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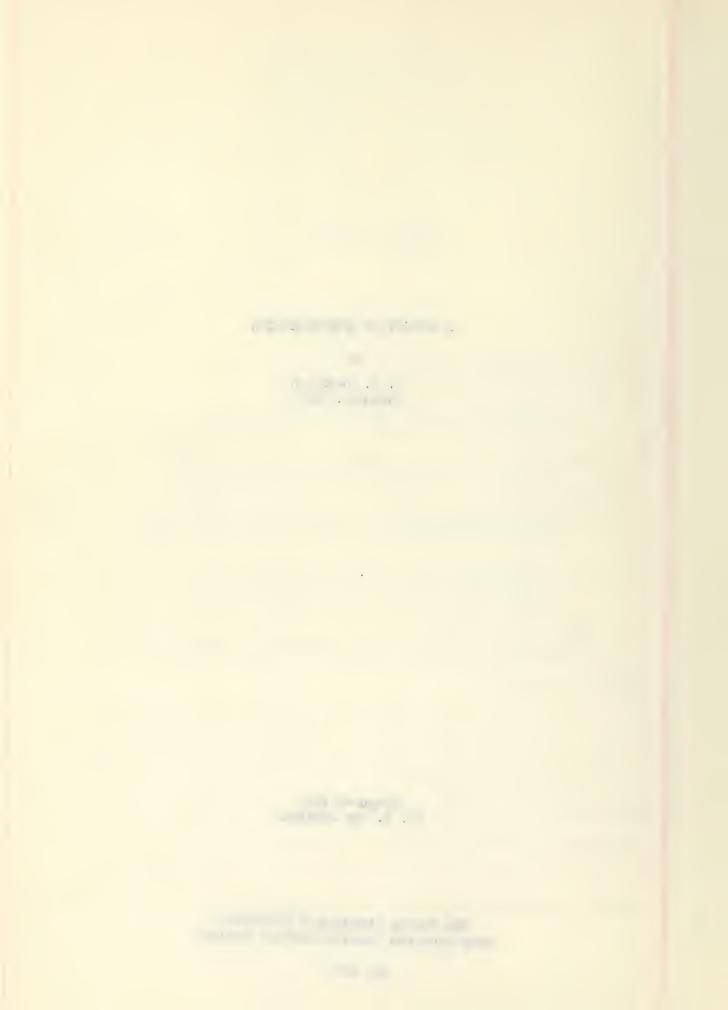
A SURVEY OF RENEGOTIATION

By

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Prepared for Dr. A. Rex Johnson

The George Washington University Navy Graduate Comptrollership Program

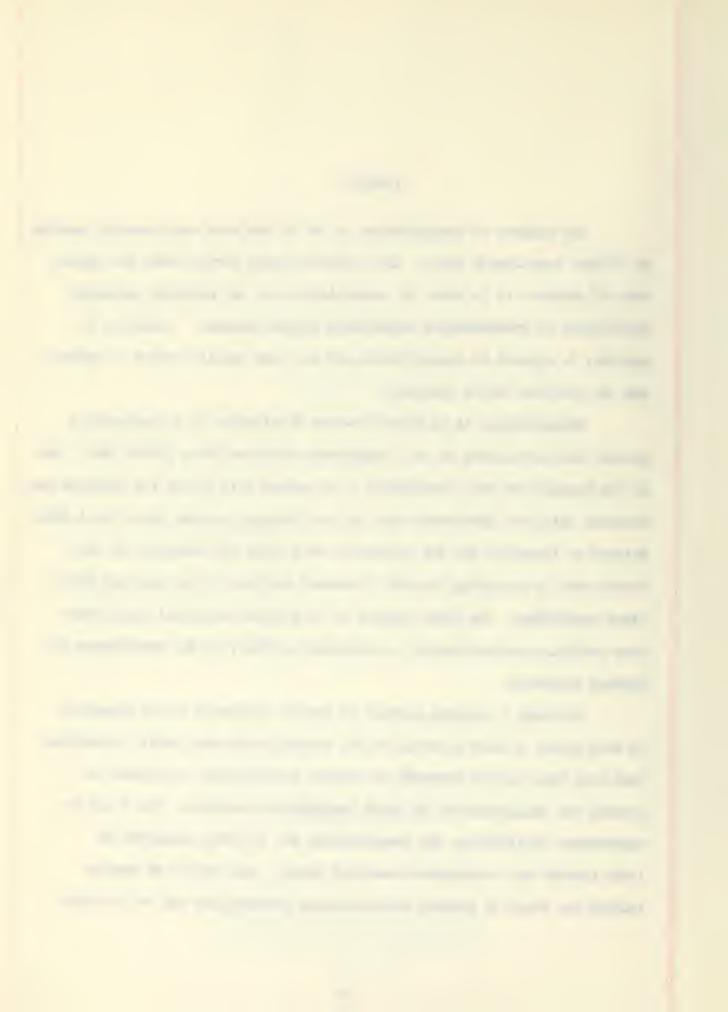


PREFACE

The subject of renegotiation is one of the most controversial aspects of defense procurement today. The Administration, particularly the Department of Defense, is in favor of renegotiation and has actively supported continuance of renegotiation legislation before Congress. Industry, in general, is opposed to renegotiation and has been equally active in defending its position before Congress.

Renegotiation is an after-the-fact examination of a contractor's profits and performance on all renegotiable business for a fiscal year. One of the purposes of this examination is to secure fair prices for articles and services which the Government must buy for defense purposes while still maintaining an incentive for the contractor to produce the materials at the lowest cost by rewarding him with increased profits for low-cost and efficient production. The other purpose is to prevent individual contractors from realizing unconscionable or excessive profits from the performance of defense contracts.

Although a complete history of profit limitation is not attempted in this paper, a brief synopsis of the various price and profit limitations that have been used in attempts to control profiteering is included to provide the background out of which renegotiation evolved. The first renegotiation legislation, the Renegotiation Act of 1942, attempted to limit profits on a contract-by-contract basis. This method of renegotiation was found to present administrative difficulties and to be unfair



to contractors. Subsequently, the Act was modified to provide examination of a contractor's over-all profits for a fiscal year. Renegotiation has followed this pattern ever since.

The wartime renegotiation legislation was permitted to expire in 1945. In 1948 defense spending began to increase and the Renegotiation Act of 1948, making certain contracts subject to renegotiation, was enacted. The coverage of renegotiation was extended to most contracts made by certain designated agencies and departments by the Penegotiation Act of 1951—the statute in effect today.

In this paper I have presented a broad survey of renegotiation, of the factors which led to its evolution, of its development through the years, and an analysis of industry's criticisms of the process. In the final chapter I have included a short summary of conclusions.

E.E.H.

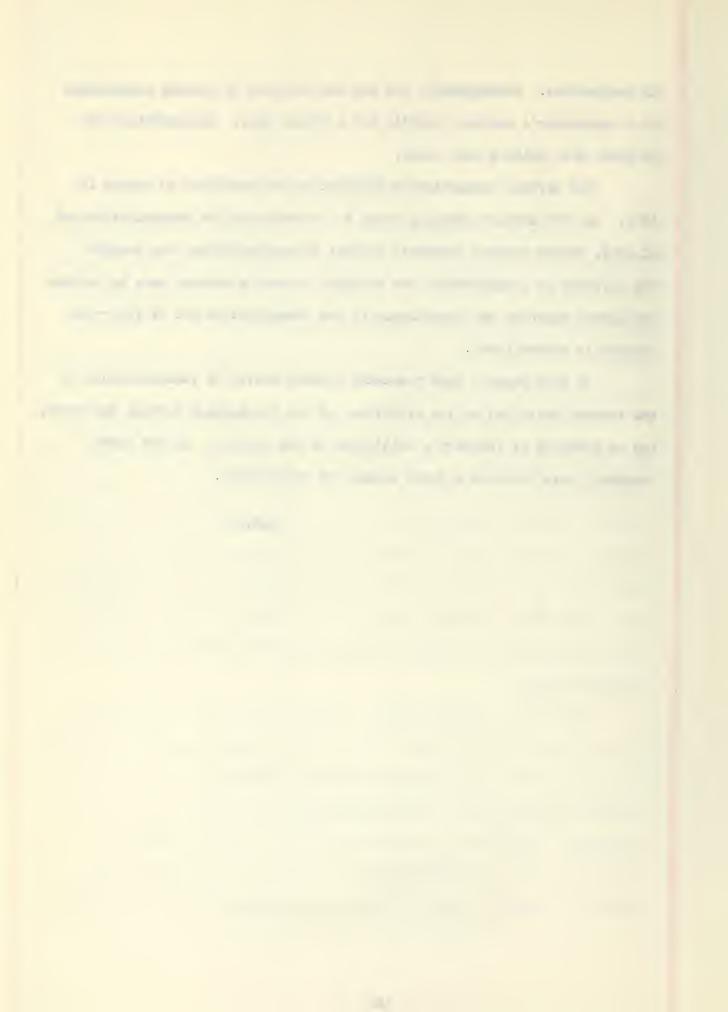
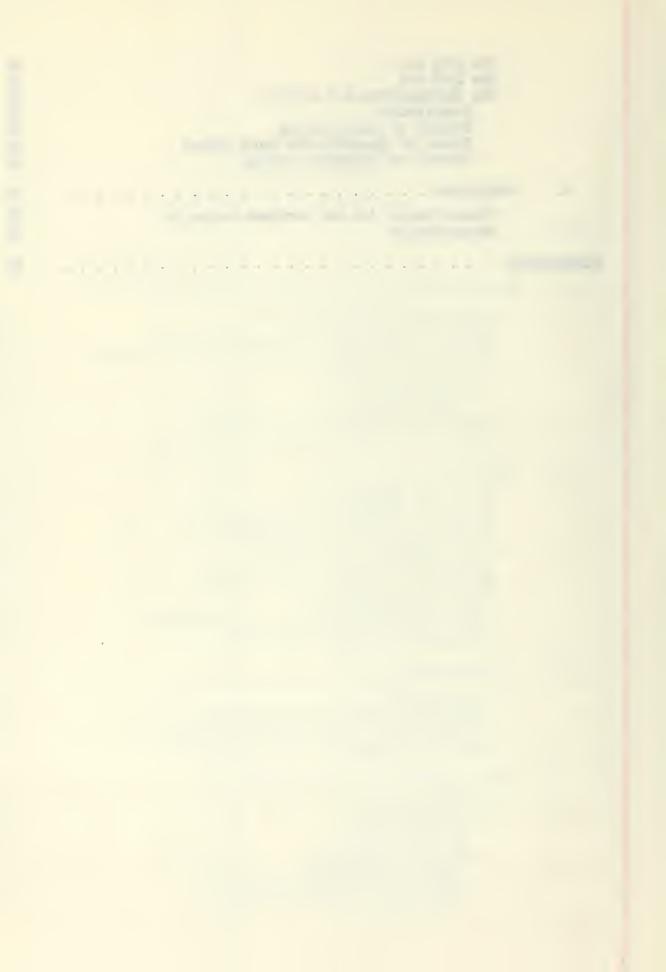


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CHAPTER I

PROFITEERING AND PROFIT CONTROLS PRIOR TO WORLD WAR II

The history of the United States is replete with examples of fortunes made through profiteering in times of strife. Most of the attempts to control and limit profiteering prior to World War II were made, with minor exceptions, by the executive branch of the Government. Congress' role was one of investigation and criticism.

Profiteering During Early Wars

During the Revolutionary War suppliers and contractors charged exorbitant prices for food and clothing of poor quality. George Washington complained in 1778 of ". . . those murderers of our cause (the monopolizers, forestallers, and engrossers) . . " and felt that "no punishment in my opinion is too great for the man who can build his greatness upon his Country's ruin." Although the Continental Congress was concerned about the costs of war and military materials, its major reaction and only effort to prevent profiteering were to recommend to the states that they limit profiteering. Some of the states passed laws fixing prices, wages, and profits, but there was no over-all profit limitation on an integrated national basis.

¹U. S. Congress, House, Committee on Military Affairs, Hearings on H.R. 3 and H.R. 5293, Taking the Profits Out of War, 74th Cong., 1st Sess., 1935, p. 590.

²U. S. Department of the Navy, NAVEXOS P-1995, Navy Contract Law (2d ed., Washington: U. S. Government Printing Office, 1959), p. 283, n. 3.

³For an excellent and detailed account of early attempts to control war profits see H. Struve Hensel and R. G. McClung, "Profit Limitations Prior to

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The Civil War again brought the subject of profiteering into the limelight. Fraud, corruption, and profiteering were rampant in military procurement. 4 Congress did not regulate profiteering, but did enact some statutes relating to bribery and other fraudulent practices. The concern over high prices was limited to government contracts for military supplies. Consequently, the burden of limiting costs fell on the executive branch, particularly on the War and Navy Departments. The Secretary of War appointed a commission to audit and adjust claims under contracts with the War Department. This Commission secured deductions of \$17,000,000 in the auditing and adjusting of \$50,000,000 in claims. The Navy Department consolidated the purchases of vessels under one purchasing agent in an attempt to improve purchasing methods and eliminate fraud. Congress in its investigative role appointed a special committee to investigate procurement malpractices. The Committee reported in 1863 that they had discovered ". . . gigantic and shameless frauds on the government . . . " and that the Committee was ". . . overwhelmed with astonishment and sorrow by the revelations."

After the Civil War, defense expenditures were negligible until the Navy began a ship construction and expansion program in the 1880's. During the reconstruction period following the war, the administration, Congress, and the citizenry were busy rebuilding the nation and the subject of profiteering and wartime fraud faded from memory.

the Recent War," Law and Contemporary Problems (Autumn, 1943), pp. 187-217.

Navy Contract Law, op. cit., p. 288. 5Tbid.

⁶ Hearings on H.R. 3 and H.R. 5293, op. cit., p. 592.

Richards C. Osborn, The Renegotiation of War Profits, University of Illinois, Bureau of Economic and Business Research Bulletin No. 67 (Urbana: University of Illinois, 1948), p. 8.

⁸ Hearings on H.R. 3 and H.R. 5293, op. cit., p. 593.

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In 1897 Congress learned that the Navy had been paying in excess of \$600 a ton for armor plate used in the construction of naval vessels. Believing this price to be unreasonable, it passed a law limiting the price to \$300 a ton. The limit was raised to \$400 a ton with the advent of the Spanish-American War and the refusal of contractors to sell at the lower price. In 1899 the price was again reduced to \$300 a ton. When it became evident that manufacturers would not sell at this price, the Secretary of the Navy was given authority to buy at prices which in his judgment were reasonable and equitable. This attempt at price fixing had resulted in failure. Profiteering during the Spanish-American War was prevalent, particularly in the area of ration procurement and the sale of contaminated beef. However, upon the return to peacetime occupations, war activities and profiteering were forgotten.

Price and Profit Controls

The onset of World War I again found the United States without a means of controlling or limiting profits and prices. Price limitations are devoted to keeping the costs of defense materials low—and may or may not involve profit limitation. Price controls are difficult to administer and, while they may be acceptable during times of war, they are repugnant to the American people during peacetime. In addition to keeping the costs of defense materials low, price limitations have a secondary purpose of preventing inflation during war—a period of increased personal financial resources and decreased availability of goods. Bernard Baruch testified before the War Policies Commission in 1931 that inflation had greatly increased the cost of the war and multiplied

⁹ Navy Contract Law, op. cit., p.289; Osborn, op. cit., p. 8.

¹⁰ Hearings on H.R. 3 and H.R. 5293, op. cit., p. 598.

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the burdens on the back of generations to come. The World War I expenditures of 39 billion dollars would have amounted to only 13 billion dollars in terms of 1913 purchasing power and 15 billion dollars in terms of 1915 purchasing power. Price controls, if universally and rigidly applied, are more effective than profit limitations and excess profits taxes in keeping down the costs of war, as prices must ultimately be based on the costs of production.

Profit limitations are primarily the attempt at a solution to a morale problem—that is, their purpose is to prevent the realization of excessive and unconscionable profits by manufacturers of war and defense materials; to prevent a few from enriching themselves at the expense of the many in a way detrimental to the welfare of the country. A secondary, and important, purpose of profit limitations is to reduce the costs of defense materials and to keep prices at a reasonable level.

Excess-profits taxes were in effect during World War I. Taxes of this type can be considered as being basically more of a revenue measure than a limitation of prices or profits. Congress enacted a tax of 12½ on profits from the production of munitions in 1915 and an 3% excess-profits tax in 1917. Neither of these can be regarded as serious attempts to limit profits.

The 8% excess-profits tax of 1917 was subsequently replaced by the War Revenue Act of 1917, which imposed rates of 20% to 60% on income above a specified rate of return on investment.

The Revenue Act of 1918 imposed a war-profits tax on corporations at the rate of 80% of the excess of net income over the average pre-war income. While not effective as a profit control measure, the act yielded substantial revenue.

¹¹ Infra, p. 16.

¹² Bernard M. Baruch, American Industry in the War (New York: Prentice-Hall, Inc., 1941), p. 381.

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Price and Profit Controls During World War I

chase of military and naval supplies during the years preceding World War I. 13 With the rapid rise in prices in 1916 and 1917, competitive bidding soon had to be abandoned because contractors refused to submit fixed price bids in the face of the uncertainty of the costs of materials and labor. This led to the use of cost-plus-a-percentage-of-cost contracts, which were supplanted by cost-plus-a-fixed-price contracts as the wastefulness of the cost-plus-a-percentage-of-cost contracts of the cost-plus-a-percentage-of-cost contracts as the wastefulness of the cost-plus-a-percentage-of-cost contracts became apparent.

During World War I three major types of attempts at profit limitation were made: (1) Cost-plus contracts, (2) Excess-profits taxation, and (3) Price fixing and control. The use of cost-plus contracts and excess-profits taxes has already been mentioned. The effectiveness of these measures in controlling profits will be developed.

Congress provided for establishment of a Council of National Defense in

August 1916. The Council was given only advisory powers and was specifically
charged with the coordination of industries and resources for the national
security and welfare, and with the creation of relations with industry which
would make possible in time of need the immediate concentration and utilization
of the resources of the nation. The Council created several administrations,
commissions, and boards, to carry out these functions. The rapidity with
which the subordinate groups were established caused confusion among the
groups as to their particular responsibilities and led to overlapping of
duties and jurisdiction. To cure these difficulties, the Council, in July
1917, created the War Industries Board to act as a coordinating agency. In
March 1918 the President removed the War Industries Board from the jurisdiction

¹³⁰sborn, op. cit., p. 8.

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of the Council of National Defense and made it an administrative agency directly responsible to himself. Bernard M. Baruch was appointed as Chairman of the reconstituted Board.

The War Industries Board through the use of a price-fixing committee fixed prices on a piecemeal basis, commodity by commodity, as expediency dictated. Nearly all prices were fixed by negotiation and agreement between the Government and the industries. The fixing of prices was not an over-all procedure, but attempts were made to control the prices for foods, fuels, and some raw materials. For these reasons the extent of price-fixing was somewhat circumscribed. In total, price fixing as practiced during World War I neither limited profits nor controlled prices.

Failure of the Controls to Limit Prices or Profits

The numerous Congressional committees that investigated war profits after the war demonstrated that none of the three methods used during World War I effectively limited war profits. None of the methods provided an incentive for a manufacturer or contractor to limit his costs or prices---and profit is the incentive in industrial activities.

A profit economy must attract manufacture of defense materials through prospect of reasonable profits, for, as someone has said, patriotism is more effective with a "slug of avarice." In a letter to the Nye Committee investigating the munitions industry, Bernard Baruch wrote in 1935:

Much as it may be decried, the cold fact remains that ours is an economy motivated by profits. A certain return on money is necessary to make our industrial system work . . . Much was said at the hearing about this being a new war psychology . . . Our whole industrial system is a complex machine built and geared to run on investment and profit. There is no proof that it will run on psychology and there is much that it will not. Certainly we should not select an hour when the enemy is at the gates to find

out whether it will or not.... Money will not invest and run the extreme risks of war for a fraction of 3 percent. 14

The emphasis during the war was on increasing production. The matter of limiting costs and profits was secondary and subordinate to building up the industries which manufactured war materials. While the three previously mentioned methods of controlling profits and costs were utilized, none were applied so stringently as to cause a possible curtailment of the production of defense materials. Investigations, particularly post-war investigations, showed that none of the methods had effectively limited war profits. One of the first reports on the subject of profiteering was made by the Federal Trade Commission in June 1918. The report stated that:

The Commission has reason to know that profiteering exists. Much of it is due to advantages taken of the necessities of the times as evidenced in the war pressure for heavy production. Some of it is attributable to inordinate greed and barefaced fraud. 15

The reasons why the methods utilized did not prevent excessive profits will be developed in the following discussion.

Cost-Plus Contracts

Cost-plus-a-percentage-of-cost contracts provide absolutely no incentive for manufacturers to minimize costs and consequently to keep down prices and limit inflation. This type of contract actually provides an incentive for the contractor to maximize his costs to maximize his profits because his profit is a percentage of the total cost incurred, and the greater the cost the greater

U. S. Congress, Senate, Special Committee on Investigation of the Munitions Industry, Preliminary Report on Wartime Taration and Price Control, Report No. 944, Part 2, 74th Cong., 1st Sess., 1935, p. 11, n. 10.

¹⁵ Hearings on H.R. 3 and H.R. 5293, op. cit., p. 605. The Committee print of the Hearings contains a reprint of the original report of the Federal Trade Commission, Senate Document 248, 65th Cong., 2d. Sess., 1918, in its entirety.



the profit. As Eugene Meyer, Jr. put it: "Self-interest will dominate altruism if the two motives are opposed instead of being harmonized." 16

The amount of profit realized by a contractor under a cost-plus-afixed-fee contract does not depend on the level of costs incurred in production. Therefore, there is not the incentive to reduce costs or increase the
efficiency of production as his amount of profit is not associated with these
factors.

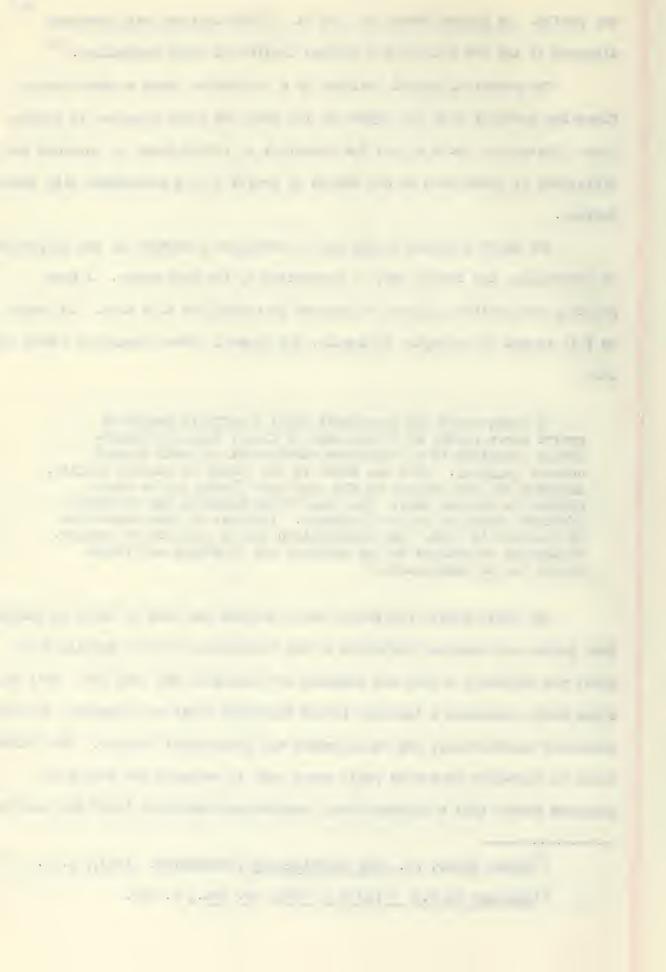
One major drawback in the use of cost-plus contracts is the difficulty of determining the actual cost of production by the contractor. A huge policing and auditing system is required to accomplish this task. In regard to this aspect of cost-plus contracts, the Federal Trade Commission stated in 1918:

In cases where the government fixes a definite margin of profit above costs, as in the case of flour, there is considerable incentive to a fictitious enhancement of costs through account juggling. This has added to the volume of unusual profits. Increase of cost showing on the producers' books can be accomplished in various ways. The item of depreciation can be padded. Officers' salaries can be increased. Interest on investments can be included in cost. New construction can be recorded as repairs. Fictitious valuations on raw material can be added, and inventories can be manipulated. 17

Any rigid profit limitation would operate too late to serve in keeping down prices and checking inflation as the limitation would be applied only after the payments, costs, and expenses of production had been met. This fact alone would encourage a tendency toward increased costs and expenses, the promotion of inefficiency, and would impede the procurement program. The limitations in cost-plus contracts would serve only to decrease the amount of apparent profit that a producer would receive and would not limit the cost of

¹⁶ Eugene Meyer, Jr., War Profiteering (Washington: 1917), p. 6.

¹⁷Hearings on H.R. 3 and H.R. 5293, op. cit., p. 606.



the product or limit the profits of subsidiary producers who manufacture the components which are incorporated in the final product on which profits are subject to the limitations in the contract.

Another difficulty with the rigid application of a percentage of cost limitation is that it would be inequitable between contractors operating under different conditions. Different types of industries require varying amounts of skill, capital, and work. Some use government furnished facilities, some do not; some manufacture standard articles, some manufacture new and unique products; some obtain capital from the government, some do not; some plants are integrated, some are merely assembly plants; some industries require a large amount of capital investment, some require a low level of capital investment; some have a high turnover, some have a low turnover; etc. Consequently, it can be seen that a rigid percentage of cost limitation would be inequitable between the various types of industries. Also, an efficient low-cost producer is penalized, while an inefficient high-cost producer is rewarded.

One of the problems of determining costs is the problem of allocating expenses to either capital or revenue expenditures. As shown by the quotation from the Federal Trade Commission report, this area provides a fertile field for padding costs by recording capital expenditures as current expense. 18

When a contractor produces both commercial and government materials under a cost-plus contract in the same manufacturing facility, the problem of segregating the costs attributable to the government manufacturing and the commercial production must be solved. Even if the manufacturer has a good accounting system and the government has an efficient auditing group, the problems of segregation and allocation defy easy solution, as the determination as to which costs are attributable to the manufacture of certain items is often a

¹⁸ Ibid.

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matter of judgment. Litigation over these problems is time-consuming and detrimental to efficient production by the manufacturer.

Price-Fixing

Price fixing also has defects when used primarily for the purpose of controlling profits, particularly when the controls are applied in a piecemeal fashion, as they were during World War I. In a time of national emergency, it is imperative that all producers—even marginal ones—be utilized in the production of war materials. Therefore, a price set high enough to provide an incentive and a profit for marginal or high-cost producers to produce will result in inordinately large profits for efficient, low-cost producers. The Federal Trade Commission report on profiteering had the following to say about the effectiveness of price-fixing in controlling profiteering: 19

The outstanding revelation which accompanies the work of cost findings is the heavy profits made by the low-cost concern under a government fixed price for the whole country. In the case of base metals, as in steel, when the government announced a fixed price, it was made so high that it would insure and stimulate production. This resulted in a wide range of profits. Under the device of cost plus a margin of profit, these profits are necessarily great in the case of the low-cost mills. Thus, while the market was prevented from running away, as it would have done undoubtedly if it had not been regulated by a fixed price, the stronger factors in the industry are further strengthened in their position and enriched by profits which are without precedent.

In addition, the fixing of prices alone does not insure against the realization of excessive profits because many manufacturers who turned to the production of war materials increased their level of production many fold without additional investment and thus increased the return on their investment to

¹⁹ Supra, p. 7.

²⁰ Hearings on H.R. 3 and H.R. 5293, op. cit., p. 605.

astronomical levels. The process whereby this increase in profits is realized, even though prices are fixed, was demonstrated to the War Policies Commission by Bernard Baruch. 21

Consider for example the simple case of a company capitalized for \$1,000,000, selling \$1,000,000 worth of goods annually, making 20 percent gross profit or \$200,000 on its turnover, and having \$100,000 of expenses of administration and selling, leaving a net profit of \$100,000 or 10 percent on both its normal turnover and its capital. Suppose, also, that 10 per cent of its costs of manufacture or \$800,000 are fixed overhead charges-depreciation, maintenance, supervision, taxes, etc. Then its costs for material and direct labor are \$720,000 for every million dollars' worth of goods it sells. Now suppose that war comes and we need the full capacity of that plant. We give it orders for \$4,000,000 worth of goods to be delivered in a single year. It has no increased selling and general administrative expense because the demand is so great no such effort is required. Neither do the fixed overhead elements of its manufacturing costs increase greatly-say only to \$90,000. What happens to the profits of that plant? Its material and direct labor costs on its \$4,000,000 sales are \$2,880,000. To this it must add \$90,000 for fixed overhead charges in its factory and \$100,000 for general and administrative expense, making a total cost of goods sold of \$3,070,000. Its net profit is therefore \$930,000 or 930 percent of its normal profits in peace. It is making nearly 100 percent on its investment and its net profit on turnover has increased from 10 percent to 23 percent. Even if we assess a tax of 80 percent on the \$830,000 of excess over peace profit, that plant will still be making \$260,000 or 260 percent of its normal profits.

I want you particularly to note that this example considers no increase in price whatever. 22

In order for price-fixing to function as an effective method of keeping down the costs of war materials, it is necessary that the program of price
control be a complete one, that is, it must cover all commodities from the raw
materials through the finished product and it must include the control of
wages of all production personnel from the raw material stage through the
finished product. In short, price controls and wage controls would have to
be established for all materials and personnel even remotely connected with

²¹ Infra, p. 16.

²² Baruch, op. cit., p. 415.

the production of a finished item. A system of this sort—in addition to being repugnant to the American people, except during time of actual war—is practically an administrative impossibility. Possibilities for evasion and avoidance of adherence to price controls through technicalities would be mumerous and the enforcement problems would be enormous.

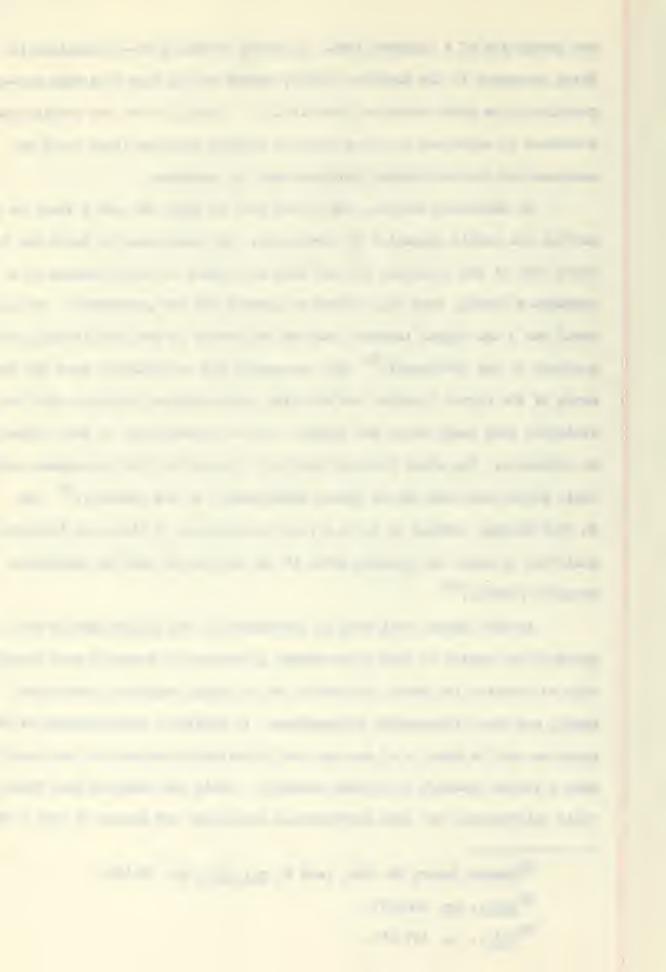
As mentioned earlier, the prices must be fixed at such a level as to provide the profit incentive for producers. The experience of World War I shows that if the producers are not assured of what in their opinion is a reasonable profit, they will refuse to produce for the government. During World War I the copper industry refused to produce at even the liberal prices proposed by the government.²³ The government had to partially meet the demands of the copper industry and threaten uncooperative producers with the statement that their mines and plants would be commandeered if they refused to cooperate. The steel industry similarly refused to fill government orders until prices had been set at levels satisfactory to the industry.²⁴ The Du Pont Company refused to build a power plant which it alone was technically qualified to build and operate until it was assured of what it considered adequate profits.²⁵

Another factor that must be considered in the implementation of a price-fixing policy is that governmental price-control agencies must largely rely on industry for their information as to costs, capacity, production needs, and other fundamental information. In addition, the personnel of these agencies must be made up of men who are industrially trained and who usually have a vested interest in private industry. While not implying that these men would deliberately and with profiteering intentions set prices at such a level

²³ Senate Report No. 944, part 2, op. cit., pp. 95-100.

²⁴ Toid., pp. 100-107.

²⁵ Ibid., pp. 107-111.



as to assure industry excessive profits at the expense of the country, it is necessary to recognize that such devices as formal severance and discontinuance of company compensation do not extinguish the real interest of an official in his company. Furthermore, they will have a tendency not to entagonize business connections of long standing and from which future benefit can be expected. These interests, plus the habits of thought and the personal associations of men who have spent their lives in private enterprise, make for a sympathetic attitude toward industrial complaints and a willingness to rely on information presented by the industry. 26

Setting prices at the costs of production plus a reasonable profit presents another problem that must be faced if a price-control system is to be effective. This would involve making future estimates of costs during a period of inflationary pressures, placing emphasis on increasing the level of production, and taking into consideration the reluctance of manufacturers to produce without being assured of reasonable profits. Bernard Baruch's plan for the control of prices, taking cognizance of the ineffectiveness of the wartime abortive piecemeal attempts to control prices, consiste essentially of freezing the upper level of prices at those in effect when war is declared, and permitting the prices to fluctuate below this ceiling in accordance with the laws of supply and demand. Then, in an area in which costs were too great to permit the manufacturer to realize an adequate profit, the prices could be revised upward, and a new ceiling would be established in that particular area.

²⁶ Ibid., pp. 73-79.

²⁷ Baruch, op. cit., passim; Cf. George P. Adams, Jr., Wartime Price Control (Washington: American Council on Public Affairs, 1942), pp. 112-142.



Excess-Profits Taxes

The excess-profits tax cannot be considered as a profit limiting device, as it limits menther profits nor costs. Primarily it is a source of revenue; during World War I it was the largest source of revenue apart from berrowing.

It is of course true that the tax recaptures part of the profits, but it does not per se limit profits. It does not provide an incentive for a contractor or producer to hold down costs and prices and, consequently, does not serve as an anti-inflationary device. In fact, the excess-profits tax provides an incentive for a producer to raise his prices so that he will have greater receipts from which he will be able to retain profits after taxes.

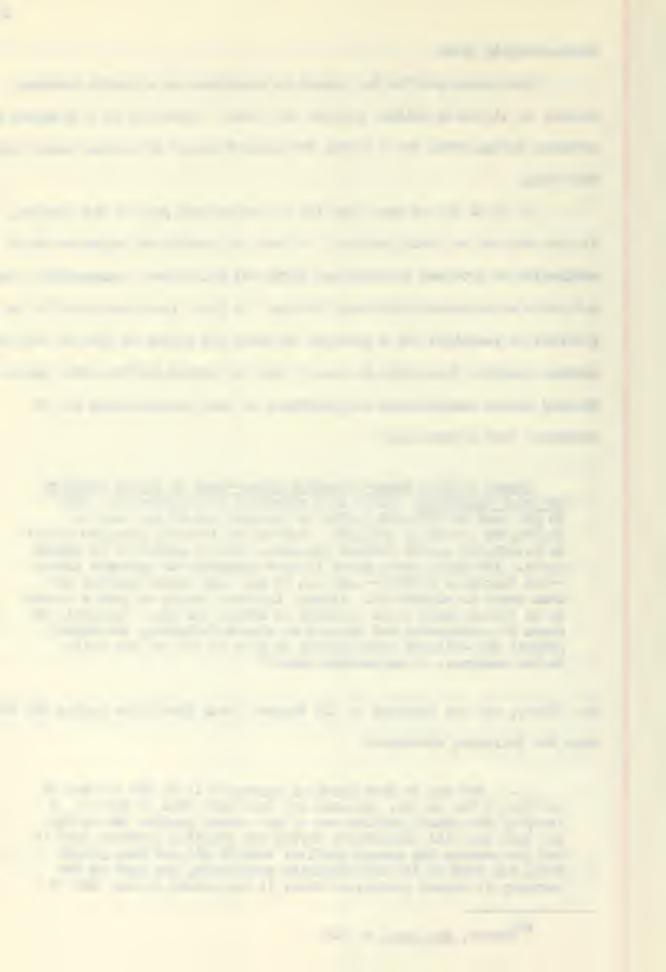
Bernard Baruch demonstrates the existence of this incentive and how it functions very effectively:

Excess profits taxes—standing alone—have no effect whatever to check inflation. Their only effect is to increase it. Thus 20 per cent of \$500,000 profit is \$100,000 and 20 per cent of \$1,000,000 profit is \$200,000. One way to increase \$500,000 profit to \$1,000,000 profit without increased risk or effort is to double price. For this reason there is more incentive to increase prices—end therefore profits—under an 80 per cent excess profits tax than there is without it. Indeed, the main result of such a system is to induce rapid price increase to absorb the tax. Precisely because it accelerates and in no wise checks inflation, the excess profits tax—without more—offers no gure at all for war evils. On the contrary, it aggravates them.

Mr. Colver, who was Chairman of the Federal Trade Commission during the war, made the following statement:

. . . the way to make anything expensive is to tax it; and if you levy a tax on war, you make war cost more than it should. A study of the actual working out of our excess profits tax during the last war will demonstrate beyond any possible question that it did not recover the excess profits; that it did not keep prices down, and that it did not stimulate production, but that on the contrary it slowed production down, it stimulated prices, and it

²⁸ Baruch, op. cit., p. 415.



made the cost of the war to the taxpayers, I should say, twice what it should have been. I would say that for every dollar collected in excess-profits taxes that got into the Treasury it cost the people of the United States, or it will cost them \$10 unnecessarily.

The excess-profits taxes formulae used during World War I were rigid complicated formulae based on return on invested capital and income on invested capital in excess of net income over the average pre-war income, and were difficult to apply, much less enforce. Both formulae required determinations as to what constituted invested capital, net income, and average pre-war income. The identification and valuation of the items that constitute these factors are clusive and difficult to identify and compute. Litigation over these taxes lasted into the early 1930's.

The Senate investigating committee investigating the munitions industry in 1935 came to the following two conclusions in regard to the use of excess profits taxes as a profit control measure:

- 1. Severe war-time texation ensures the subjecting of the administrative officials responsible for its operation to heavy direct and indirect pressure for the alleviation of tax burdens, it increases resistance to tax collection, and if it reaches a level which the majority of businessmen feel is confiscatory, will discourage or prevent the volume of production so essential to the successful prosecution of a major war and thus defeat its own ends.
- 2. Because of the difficulties of determining in any exact manner the cost of all business and hence the profits from business and because of the impossibility of closing all loopholes in legislation designed to apply uniformly to our immense and complicated business and industrial structure, income taxation cannot eliminate all war profits. 30

²⁹U. S. Congress, House, Hearings Before the Committee on Military Affairs, 68th Cong., 1st Sess., 1924, p. 237; quoted in Senate Report No. 944, Part 2, op. cit., p. 9.

³⁰ Senate Report No. 944, Part 2, op. cit., p. 6.



Reaction to World War I Profiteering

After the war the investigators and political orators castigated those who had "profitted from the slaughter." The public was vocally critical of those who had profited from the war and those who had permitted profiteering to take place. One of the widespread claims that the war had produced 23,000 new millionnaires was repeated and amplified. This statement was obviously greatly exaggerated. An examination of the statistics of tax returns as stated by the Bureau of Internal Revenue indicates very strongly that the statement is false. However, the number of returns indicating personal incomes above \$50,000 per year increased from 7,500 in 1914 to 19,103 in 1917. The subject of profiteering became a political football that was used by both major political parties. Both parties gave their support in 1924 and again in 1928 to the prevailing sentiment for a survey of the whole gamut of war policies. After a few years of peace the public, in general, returned to peacetime pursuits and problems and left the subject of excessive profits to congressional committees.

The American Legion was particularly active in keeping the subject before Congress and was instrumental in introducing several bills to control profits. The One of the major war profits investigating groups was the War Policies Commission created pursuant to Public Resolution 98, 71st Congress, June 27, 1930. The Commission was given the task "to study and consider amending the Constitution of the United States to provide that private property may

³¹ Osborn, op. cit., p. 48; U. S., Congress, House, Committee on Military Affairs, Preventing Profiteering in Time of War, and to Equalize the Burdens of War and thus Provide for the National Defense and Promote Peace, Report No. 1870, 75th Cong., 3d Sess., 1938, p. 3.

³² Hearings on H.R. 3 and H.R. 5293, op. cit., p. 619.

³³U. S. Congress, House, Report of the War Policies Commission, House Document No. 163, 72d Cong., 1st Sess., 1931, p. viii.

³⁴ Hearings on H.R. 3 and H.R. 5293, op. eit., pp. 9-37.



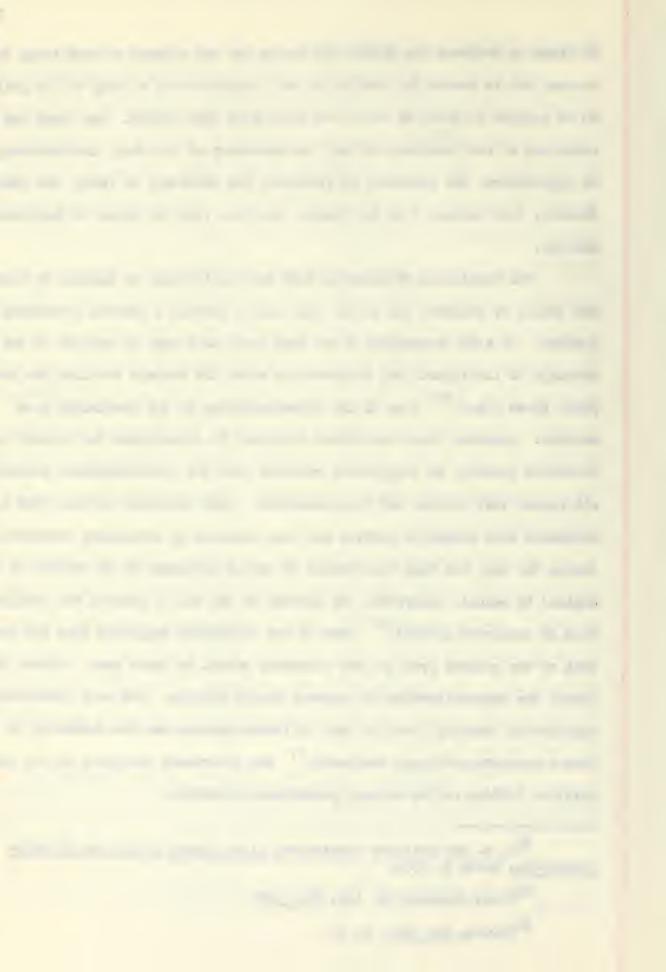
be taken by Congress for public use during war and methods of equalizing the burdens and to remove the profits of war, together with a study of the policies to be pursued in event of war. ——A formidable task indeed! The group was comprised of the Secretary of War, the Secretary of the Navy, the Secretary of Agriculture, the Secretary of Commerce, the Secretary of Labor, the Attorney General, four members from the Senate, and four from the House of Representatives.

The Commission recommended that the Constitution be amended to permit the taking of property for public use, and to provide a control of wartime profits. It also recommended a tax that would take away 95 percent of the carnings of individuals and corporations above the average earnings for the prior three years. 35 None of the recommendations of the Commission were adopted. Numerous other committees continued to investigate the subject of excessive profits; no legislation resulted from the investigations, although all agreed that profits had been excessive. Both political parties were in agreement that excessive profits had been realized by Government contractors during the war, but they were unable to secure agreement as to methods to be applied to equally distribute the burdens of war and to prevent the realization of excessive profits. 36 Some of the committees suggested that 100 percent of the profits from the war contracts should be taxed away. Others discussed the nationalization of industry during wartime. The only beneficial legislation stemming from the mass of investigations was the outlawing of costplus-a-percentage-of-cost contracts.37 The government continued to use competitive bidding as the primary procurement procedure.

³⁵U. S. War Policies Commission, Final Report of the War Policies Commission, March 5, 1932.

³⁶ House Document No. 163, loc. cit.

³⁷⁰sborn, op. cit., p. 9.



Vinson-Trammel Act and Merchant Marine Act

The first passage of peacetime profit controls came in 1934 with the passage of the Vinson-Traumel Act. 38 This law was enacted to authorize the expansion of the Navy and to provide for a limitation of profits on contracts for the construction of naval vessels and naval aircraft. It stated that profits on contracts for the construction of naval vessels and aircraft in excess of \$10,000 would be limited to 10 per cent of the contract price, and that any profits above this limitation would be paid into the United States Treasury.

The Vinson-Trammel Act was amended in June, 1936³⁹ to permit application of the 10 per cent limitation to the aggregate contract prices for all contracts completed within the taxable year, and to permit losses on some contracts to be set off against profits realized on other contracts. In addition, the amendment permitted losses for one taxable year to be offset against net profits of the succeeding taxable year.

The Merchant Marine Act of 1936 extended the 10 per cent limitation on profits to contracts for ships built for the Maritime Commission. 40 It also included some provisions for the computation of costs. For example, no more than \$25,000 in annual salary for any individual could be counted as a cost in the fulfillment of a ship construction contract.

In April, 1939 the Vinson-Trammel Act was further amended to be applicable also to contracts for Army aircraft. 41 The profit limitation of 10

³⁸ U. S., Congress, Public Law 135, 73d Cong., 2d Sess., 1934; 48 gtat. 505.

³⁹U. S., Congress, Public Law 804, 74th Cong., 2d Sess., 1936; 49 stat.

^{40.} S., Congress, Public Law 835, 74th Cong., 2d Sess., 1936; 49 Stat. 1985, 1998.

⁴¹ U. S., Congress, Public Law 18, 76th Cong., 1st Sess., 1939; 53 stat. 560.



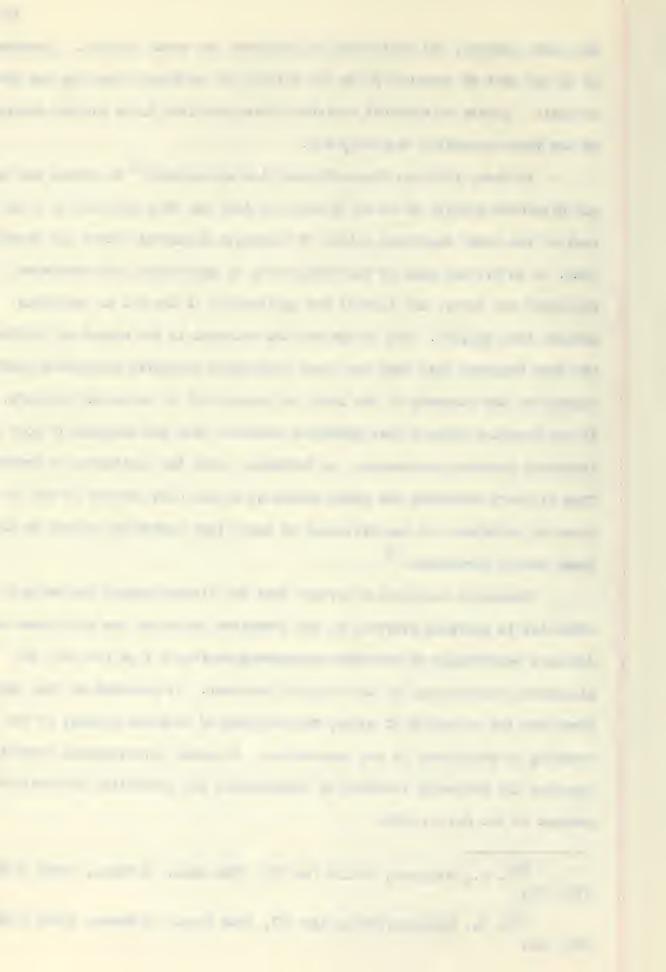
per cent, however, was restricted to contracts for naval vessels. A maximum of 12 per cent of contract price was allowed for contracts for Army and Navy aircraft. Losses on aircraft contracts were permitted to be carried forward to the four succeeding taxable years.

In June, 1940 the Vinson-Tremmel Act was amended to reduce the maximum allowable profits on naval vessels and Army and Navy aircraft to 8 per cent of the total aggregate prices of contracts completed within the taxable year, or to 8.7 per cent of the total costs of performing such contracts, whichever was lower, and limited the application of the Act to contracts greater than \$25,000. The reason for the decrease in the amount of profits was that Congress felt that the lower limitation permitted sufficient profits because of the increase in the level of procurement of ships and aircraft. It was becoming evident that peacetime measures were not designed to cope with increased wartime procurement. In September, 1940 the limitation on profits from aircraft contracts was again raised to 12 per cent because of the increasing reluctance of manufacturers to enter into contracts subject to the lower profit limitation. 43

Hindsight examination reveals that the Vinson-Trammel Act was not very effective in limiting profits, as the contracts let under the provisions of the Act were essentially of cost-plus-a-percentage-of-cost type with all the attendant disadvantages of this type of contract. It provided no real incentives for the reduction of costs, the lowering of contract prices, or the increasing of efficiency by the contractors. A Senate investigating committee reported the following reaction by shipbuilders and associated contractors to passage of the Act in 1934:

¹⁴²U. S., Congress, Public Law 781, 76th Cong. 3d Sess., 1940; 54 Stat. 676, 677.

⁴³U. S., Congress, Public Law 781, 76th Cong., 3d Sess., 1940; 54 stat. 872, 833.



Various of the companies stated on the stand that they had in no way opposed this bill.

Very shortly after the bill was passed the shipbuilders and the large suppliers and Navy subcontractors, and later the comptrollers of these various groups, got together in long sessions to determine how the interpretations of the bill could be arranged to suit their interest. The main question was how to increase costs.

In regard to obtaining compliance with the provisions of the Act by an audit of their accounting records, the report stated: "... there is absolutely no effective control of costs possible without a huge policing system of auditors and inspectors constantly on the premises."

Contractors in 1940 were reluctant to enter into government contracts, particularly for the production of aircraft, because of the profit limitations and the availability of more lucrative contracts for expanding foreign and domestic markets which could be let without restraint or restriction. This reluctance was delaying the defense program in its rapid build-up of the armed forces. This is another respect in which it can be said that the Vinson-Trammel Act was a failure in the attempt to walk the path between the realization of excessive profits by contractors and the refusal of contractors to produce.

The passage of the Second Revenue Act of 1940⁴⁶ brought the imposition of the first excess-profits tax. The profit limitations of the Vinson-Trammel Act, as amended, were suspended on naval and military contracts whenever the contractors and subcontractors were subject to the excess-profits tax. Most of the limitations of the Merchant Marine Act of 1936 were suspended under the same conditions.

W. S., Congress, Senate, Special Committee on Investigation of the Munitions Industry, Preliminary Report on Naval Shipbuilding, 74th Cong., 1st Sess., 1935, p. 323.

⁴⁵ Toia., p. 324.

⁴⁶ Public Law 801, 76th Cong., 36 Sess., 1940; 54 Stat. 974; 1003, 1004.



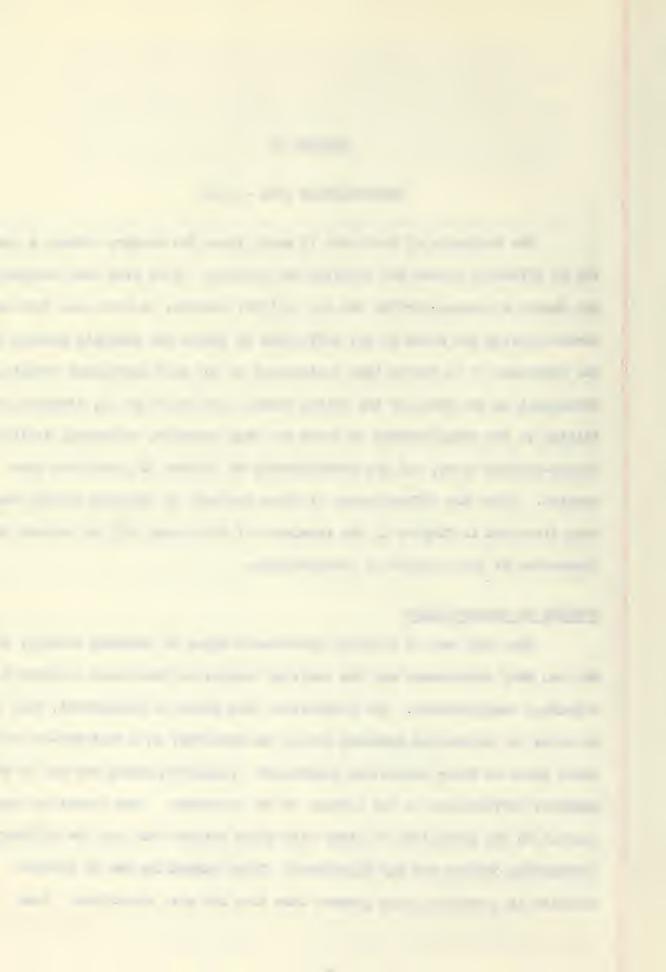
CHAPTER II

RELE OTIATION 1942 - 1950

The beginning of World War II again found the country without a plan for an effective system for limiting war profits. It is true that Congress had passed an excess-profits tax law in 1940; however, we have seen that an excess-profits tax alone is not sufficient to insure the adequate pricing of war materials or to insure that contractors do not make exorbitant profits. Subsequent to the entry of the United States into World War II, statutes pertaining to the establishment of price and wage controls, rationing, additional excess-profits taxes, and the establishment of systems of priorities were enacted. Since the effectiveness of these controls in limiting profits has been discussed in Chapter I, the remainder of this paper will be devoted to a discussion of the practice of renegotiation.

Prelude to Renegotiation

When the rate of military procurement began to increase rapidly, the War and Navy Departments and the Maritime Commission introduced a system of voluntary renegotiation. The contractors were asked to renegotiate, that is, to agree to redetermine contract prices retroactively on a contract-by-contract basis based on their production experience. Adequate pricing was one of the greatest difficulties in the letting of war contracts. Some industries had to convert to the production of items with which neither they nor the military contracting officer had any experience. Other industries had to produce articles in quantities much greater than they had ever visualized. Some



system or method was required which would encourage production and reward efficiency, but which would not allow excessive profits to accrue to the war contractor.

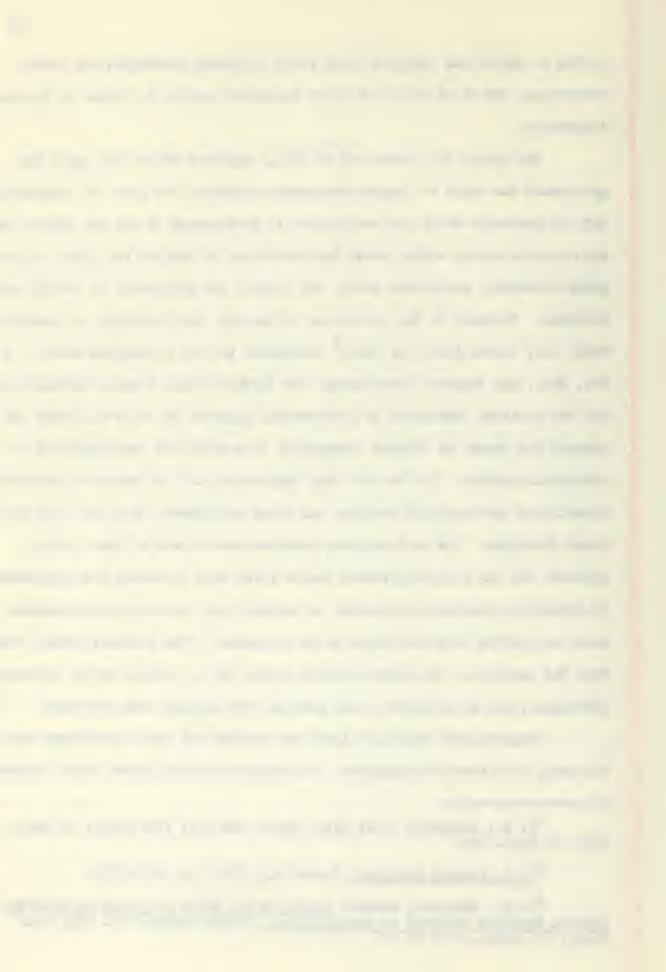
The Second War Powers Act of 1942, approved March 1942, gave the government the right to inspect the plants and audit the books of contractors who had contracts which had been placed in furtherance of the war effort, and also gave an agency acting under the provisions of the Act the right to subpoens witnesses, administer oaths, and require the submission of records and evidence. Pursuant to the provisions of the Act, the President, by Executive Order 9217 issued April 10, 1942, designated the War Production Board; the War, Navy, and Treasury Departments; the Reconstruction Finance Corporation; and the Maritime Commission as governmental agencies to audit the books and inspect the plants of defense contractors to prevent the realization of unreasonable profits. The War and Navy Departments and the Maritime Commission established cost-analysis sections and price adjustment boards to carry out these functions. The cost-analysis sections were to act as fact finding agencies for the price-adjustment boards which were to assist the departments in obtaining voluntary adjustments or refunds from the contractors whenever costs or profits were considered to be excessive. The Executive Order stated that the purpose of the administrative action was to control costs, to promote efficiency, and to eliminate undue profits from hastily made contracts.

Congressional action to limit war profits was being considered concurrently with these developments. The decision of the United States Supreme

U. S., Congress, Title XIII, Public Law 507, 77th Cong., 2d Sess., 1942; 56 Stat. 185.

²U. S. Federal Register, Volume VII, 1942, pp. 2753-2754.

³U. S., Congress, Senate, Report of the Joint Committee on Internal Revenue Taxation Relating to Renegotiation, Senate Document No. 126, 84th Cong., 2d. Sess., 1956, p. 44.



Court on February 16, 1942 that the Bethlehem Steel Corporation could retain large World War I profits, because there had been no contractual arrangement for the recoupment of excessive profits by the government, made it evident that specific legislation would be necessary if excessive profits were to be denied to government contractors. The Court stated this in the following words:

The problem of war profits is not new. In this country, every war we have engaged in has provided opportunities for profiteering and they have been too often scandalously seized. See Hearings before the House Committee on Military Affairs on H.R. 3 and H.R. 5293, 74th Cong., 1st Sess., 590-598. To meet this recurrent evil, Congress has at times taken various measures. It has authorized price-fixing. It has placed a fixed limit on profits, or has recaptured high profits through taxation. It has expressly reserved for the Government the right to cancel contracts after they have been made. Pursuant to Congressional authority, the Government has requisitioned existing production facilities or itself built and operated new ones to provide needed war materials. It may be that one or some or all of these measures should be utilized more comprehensively, or that still other measures must be devised. But if the Executive is in need of additional laws by which to protect the nation against war profiteering, the Constitution has given to Congress, not to this Court, the power to make them.

The Renegotiation Act of 1942

Section 403 of the Sixth Supplemental National Defense Appropriations Act, 1942, 5 approved April 28, 1942—commonly referred to as The Renegotiation Act of 1942—was the first legislation which pertained to the renegotiation of excessive profits of defense contractors. The Act directed the Secretaries of the War and Navy Departments, and the Chairman of the Maritime Commission, to insert in any contract in excess of \$100,000 a provision for the renegotiation of the contract price at such periods as when, in the judgment of the Secretary, the profits could be determined with reasonable certainty. Contractors were required to insert the clause in subcontracts in excess of

United States v. Bethlehem Steel Corporation 315 U.S. 289 (1942).

⁵U. S., Congress, Public Lew 528, 77th Cong., 2d Sess., 1942; 56 Stat. 226, 245-246.



\$100,000. The term "renegotiation" included the refixing by the Secretary of the contract price. The Act further provided for the retention or repayment of excessive profits when, in the opinion of the Secretary, "excessive profits have been realized or are likely to be realized." The profits recovered were to be deposited in the Treasury as miscellaneous receipts. The Act was applicable to contracts, whether or not they contained the renegotiation clause, on which final payment had not been made prior to the effective date of the Act, April 28, 1942. It was to remain in effect for the duration of the war and for three years after termination of the war.

The authority to conduct renegotiation proceedings was vested in the Secretaries of the War and Navy Departments and the Chairman of the Maritime Commission who were permitted to redelegate the authority to other agencies or individuals, and could authorize redelegation of the authority by these agencies or individuals. Renegotiation was to be conducted on a contract-by-contract basis; however, no guidelines were laid down to be used in determining whether profits were excessive except that the Secretaries were directed not to make allowances for salaries, bonuses, or other compensation paid by a contracting company to its officers and employees in excess of a reasonable amount. Nor could they make allowances for any excessive reserves set up by the contractor or for any costs incurred by the contractor which were excessive or unreasonable. The agencies would have the same right to require the submission of data and to conduct audits as delineated in the Second War Powers Act.

An examination of the provisions of the Act shows that it was intended to accomplish two functions: (1) the adjustment of the contract price to an amount which would have been considered reasonable if all of the facts had been known when the contract was let, and (2) the recapture of excessive profits which had been realized in the performance of contracts with the three



named agencies. It should be noted that the Government had the unilateral power to determine the excessiveness of profits. No provision was made for the judicial review of disagreements by aggrieved contractors.

Because of the vagueness and the newness of the original Act, difficulties in its administration soon became apparent. The major difficulty was the renegotiation of contracts on an individual or contract-by-contract basis. To overcome this time-consuming and difficult practice, the departments began to renegotiate contracts on a fiscal year basis, that is, all of the contracts that a contractor completed within a fiscal year were renegotiated as a unit, which emphasized the recapture aspects of the legislation more than the repricing aspects.

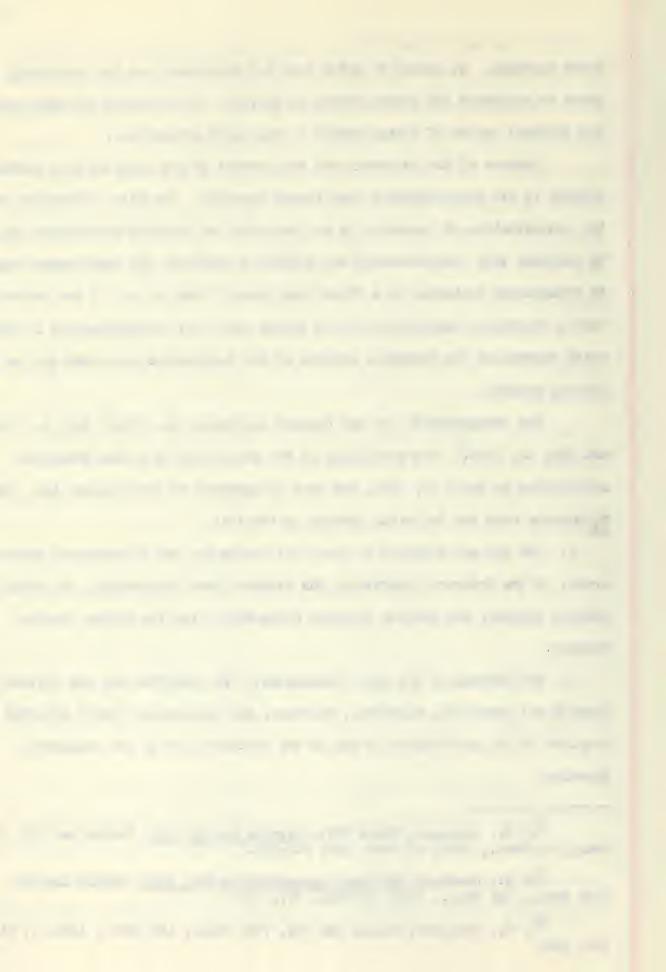
The Renegotiation Act was amended on October 21, 1942; July 1, 1943; and July 14, 1943. The provisions of the amendments were made effective retroactive to April 28, 1942, the date of approval of the original Act. The amendments made the following changes in the Act:

- 1. The Act was extended to cover the contracts, and subcontracts thereunder, of the Treasury Department, the Defense Plant Corporation, the Metals Reserve Company, the Defense Supplies Corporation, and the Rubber Reserve Company.
- 2. The meaning of the term "subcontract" was clarified and was defined to include all materials, machinery, services, and commissions [above \$25,000] required in the performance of one of the contracts let by the designated agencies.

U. S., Congress, Title VIII, Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., 1942; 56 Stat. 798, 982-985.

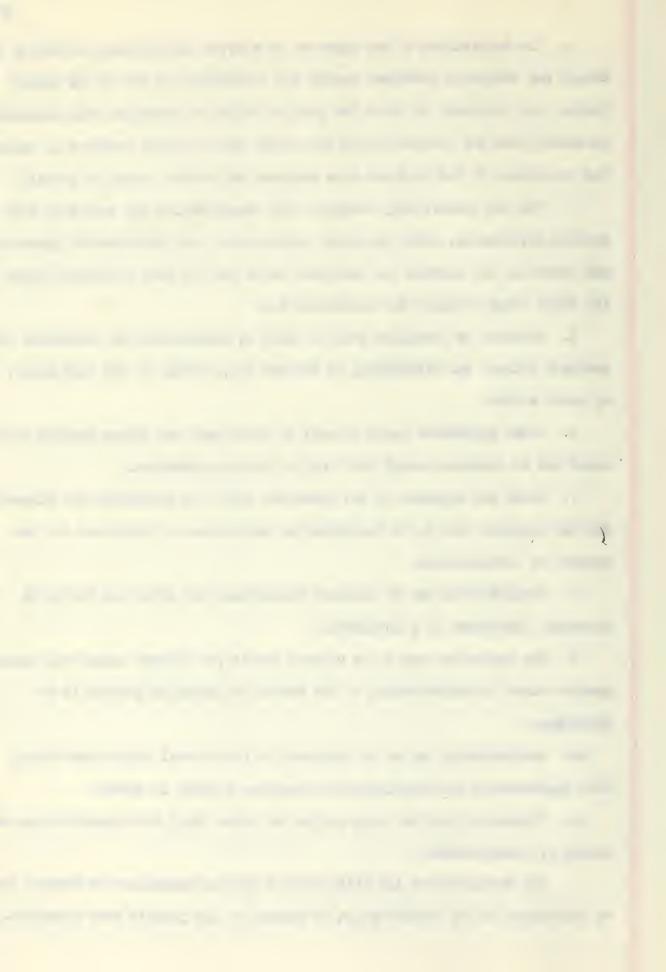
⁷⁸th Cong., lst Sess., 1943; 57 Stat. 347, 348.

⁸U. S., Congress, Public Law 149, 78th Cong., 1st Sess., 1943; 57 Stat. 564, 565.



- 3. The Secretaries of the agencies were given discretionary authority to exempt any contracts performed beyond the continental limits of the United States, any contracts in which the profits could be determined with reasonable certainty when the contract price was established, and any contract in which the provisions of the contract were adequate to prevent excessive profits.
- b. The Act specifically exempted from renegotiation any contracts with foreign governments, other political subdivisions, and governmental agencies; and contracts for certain raw materials which had not been processed beyond the first stage suitable for industrial use.
- 5. Recovery of excessive profits could be accomplished by reductions in contract prices, the withholding of amounts due, refunds by the contractor, or by court action.
- 6. Final agreements could be made to cover past and future periods which could not be reopened except for fraud or misrepresentation.
- 7. Costs and expenses of the character which the contractor was allowed for tax purposes were to be recognized as exclusions or deductions for the purpose of renegotiation.
- 8. Renegotiation had to commence within one year after the filing of financial statements by a contractor.
- 9. The contractor was to be allowed credit for Federal income and excessprofits taxes in determination of the amount of excessive profits to be
 eliminated.
- 10. Renegotiation was to be conducted on an over-all fiscal-year basis, thus implementing the administrative practices already in effect.
- 11. "Excessive profits" were defined as those found to be excessive as a result of renegotiation.

The Renegotiation Act still did not provide guidelines or factors to be considered in the determination of whether or not profits were excessive.



To fill this gap, the War, Navy, and Treasury Departments and the Maritime

Commission issued a joint statement in March, 1943 setting forth the general

principles followed in determining excessive profits, the particular factors

considered in the determination of excessive profits, and the departments'

interpretations of the statute. The particular factors considered in the determination of excessive profits by the price adjustment boards of the departments included the following:

- 1. Manner in which a contractor's operations compared with other contractors with respect to the following factors:
 - a. Price reductions and comparative prices
 - b. Efficiency in reducing costs
 - c. Economy in the use of raw materials
 - d. Efficiency in the use of facilities and the conservation of manpower.
 - e. Character and extent of subcontracting
 - f. Quality of production
 - g. Complexity of manufacturing technique
 - h. Rate of delivery and turnover
 - i. Inventive and developmental contribution
 - j. Cooperation with the Government and other contractors in developing and supplying technical assistance.
 - 2. Risks assumed by a contractor such as:
 - a. Inexperience in new types of production
 - Delays from inability to obtain materials, rejections,
 spoilage, and "cut-backs" in quantities
 - c. Guarantees of quality and performance
 - d. Reasonable pricing policies

3. Possible increases in the costs of materials and wages.9

The trend of the emphasis in renegotiation away from its use, as a specific repricing technique toward its use as a method of recapture of excessive profits, while maintaining incentives in the form of a higher profit allowance for efficient and economic production, can be seen. The factors that were considered in the determination of excessive profits were based on the premise of maintaining maximum productive output at the lowest possible cost. In order to achieve this purpose, the contractor who contributed the most in the way of cost reduction was rewarded with a larger amount of profit than the inefficient high-cost producer.

Reaction of Industry to Renegotiation

Richards C. Osborn summarizes the views of business groups on the subject of renegotiation, as represented at congressional hearings, very succienctly:

In the press and in extended congressional hearings concerning the extension of the 1942 Act, many business groups, large and small, vociferously declared "this can't be done to us." They lambasted the Act as wholly un-American, unconstitutional, unnecessary, ill-advised, or detrimental to the war effort and the economic stability of the country. These and other businessmen prefaced their remarks, however, with a statement that excessive profits should not be made from the war. As a matter of strategy, their specific proposals dealt primarily with revisions that would emasculate the Act; they did not advocate its outright appeal. Each industrial group considered itself to be a special case and suggested amendments to the law which would reduce drastically or eliminate recoveries from their own profits. 10

⁹U. S., Department of War, Joint Statement by the War, Mavy and Treasury Departments and the Maritime Commission of Purposes, Policies, and Interpretations under Section 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, as Amendea (Washington: U.S. Government Printing Office, 1943), p. 8.

¹⁰ Osborn, op. cit., p. 19.

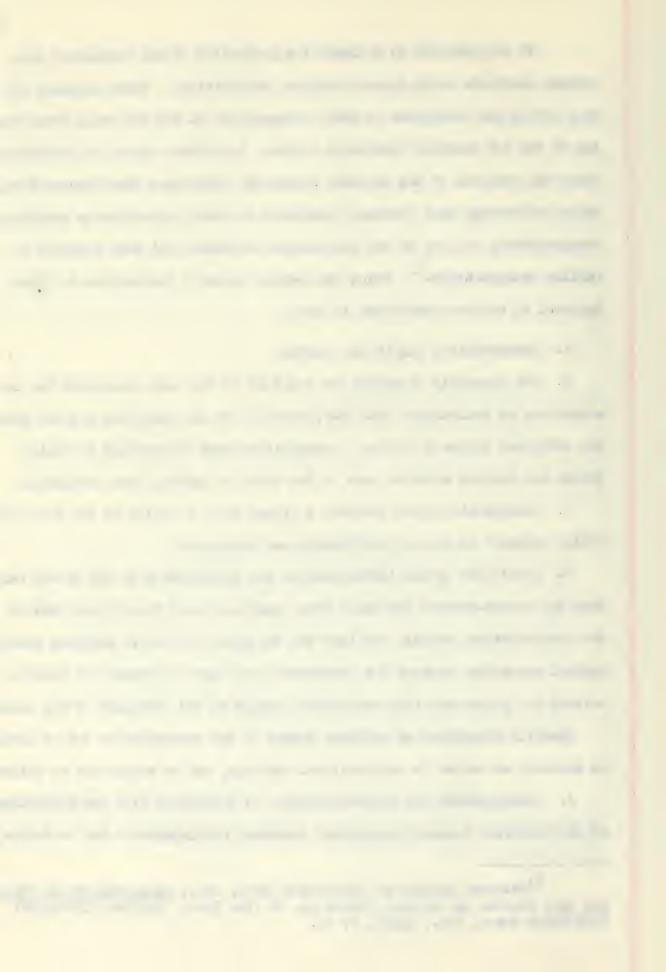
It is difficult to estimate the proportion of all businesses with defense contracts which opposed wartime renegotiation. Those opposing the Act were active and vociferous in their demunciation of the Act while those approving of the Act remained relatively silent. A post-war survey of businessmen under the amspices of the National Industrial Conference Board showed that, while businessmen were virtually unanimous in their opposition to peacetime renegotiation, six out of ten businessmen indicated that they approved of wartime renegotiation. Among the reasons given by businessmen for their approval of wartime renegotiation were:

- 1. Renegotiation limitel war profits.
- 2. The necessity of having war supplies at any cost, and, since the inexperience of contractors with the production of war materials did not make for efficient contract pricing, renegotiation made it possible to review prices and correct mistakes made in the haste of getting into production.
- 3. Renegotiation gave industry a "clean bill of health in the court of public opinion" as far as profiteering was concerned.
- 4. About half of the industrialists who participated in the survey said that the excess-profits tax would have recaptured more than 70 per cent of the renegotiation refunds, but that the tax alone was not an adequate profit control mechanism, because the contractor could have increased his profits by raising his prices and thus benefitted himself to the detriment of his country.

Specific objections of business groups to the Renegotiation Act of 1942, as amended, as voiced in congressional hearings, can be summarized as follows:

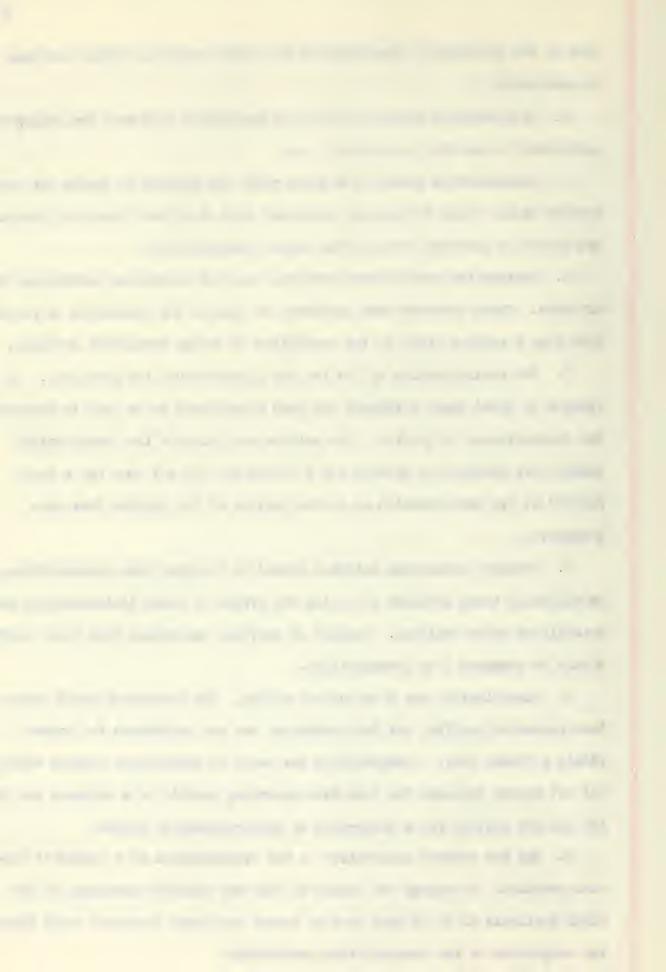
1. Renegotiation was time-consuming. It interfered with the production of war materials because experienced personnel and management had to devote

National Industrial Conference Board, Inc., Renegotiation in Peace and War, Studies in Business Policy No. 44 (New York: National Industrial Conference Board, Inc., 1950), p. ii.



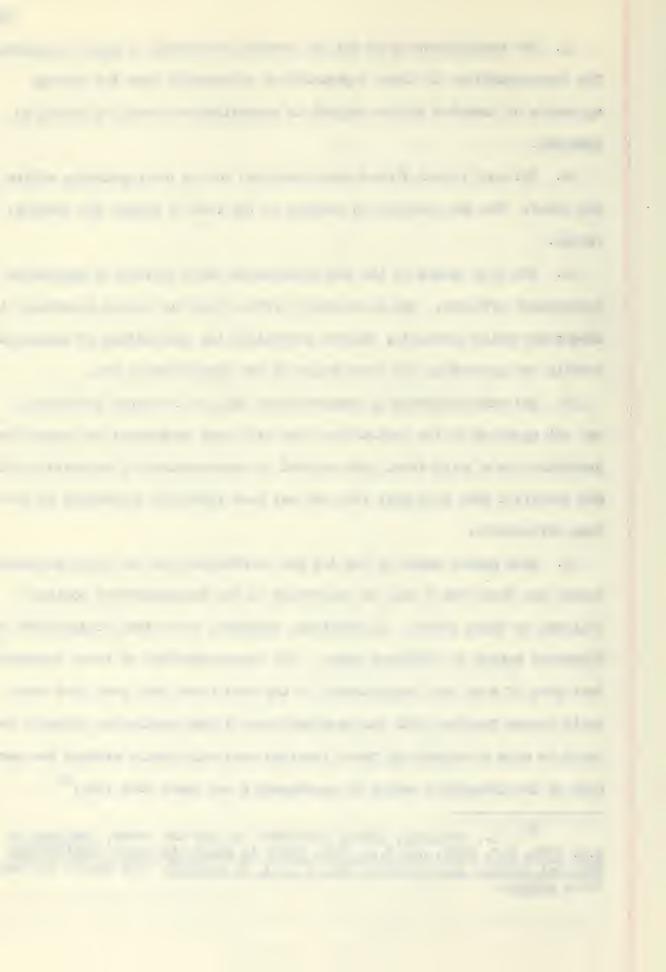
time to the problems of renegotiation that could have been better utilized in production.

- 2. Renegotiation interfered with the sanctity of contracts and substituted government by men for government by less.
- 3. Renegotiation should take place after the payment of income and excess profits taxes. Some businessmen contended that taxes were a cost of business and should be deducted from profits before renegotiation.
- 4. Postwar and reconversion reserves were not allowed as deductible items of costs. These reserves were necessary to finance the conversion of production from a wartime basis to the production of normal commercial articles.
- 5. The administration of the Act was discretionary and arbitrary. No formula or fixed legal standards had been established to be used to determine the excessiveness of profits. The methods and rules of the renegotiation boards were shrouded in mystery and a contractor did not know how a board arrived at its determination as to the portion of his profits that were excessive.
- 5. Standard commercial articles should be exempted from renegotiation, particularly those articles for which the Office of Price Administration had established price ceilings. Vendors of services maintained that their profits should be exempted from renegotiation.
- 7. Renegotiation was a unilateral action. The government could recapture excessive profits, but the contractor was not reimbursed for losses within a fiscal year. Renegotiation was based on book-profit figures which did not always indicate the long-term operating results of a business and the Act did not provide for a carry-back or carry-forward of losses.
- 8. The Act created uncertainty in the determination of a company's financial position. A company was unable to have any definite knowledge of the funds available to it to take care of normal corporate functions until after the completion of the renegotiation proceedings.



- 9. The administration of the Act created a hardship on small companies. The representatives of these organizations recommended that the minimum aggregate of contract prices subject to renegotiation should be raised to \$500,000.
- 10. The only appeal from a board decision was to the appointing office of the board. The Act provided no redress in the form of appeal for judicial review.
- 11. The very nature of the Act discouraged close pricing by government procurement officers. The procurement officers had had enough experience to adequately price contracts, thereby preventing the realization of excessive profits and permitting the termination of the Renegotiation Act.
- 12. The administration of renegotiation did not encourage efficiency. It was not apparent to the contractors that efficient management and economical production were being taken into account in determination of excessive profits and therefore they felt that they did not have financial incentives to produce efficiently.
- 13. Each agency named in the Act had established its own price adjustment boards and there was a lack of uniformity in the administrative policies followed by these boards. In addition, companies were often renegotiated by different boards in different years. The representatives of these companies felt that if they were renegotiated by the same board each year that board would become familiar with the peculiarities of that particular industry and would be able to accomplish their function more efficiently without the necessity of the industry's having to re-educate a new board each year. 12

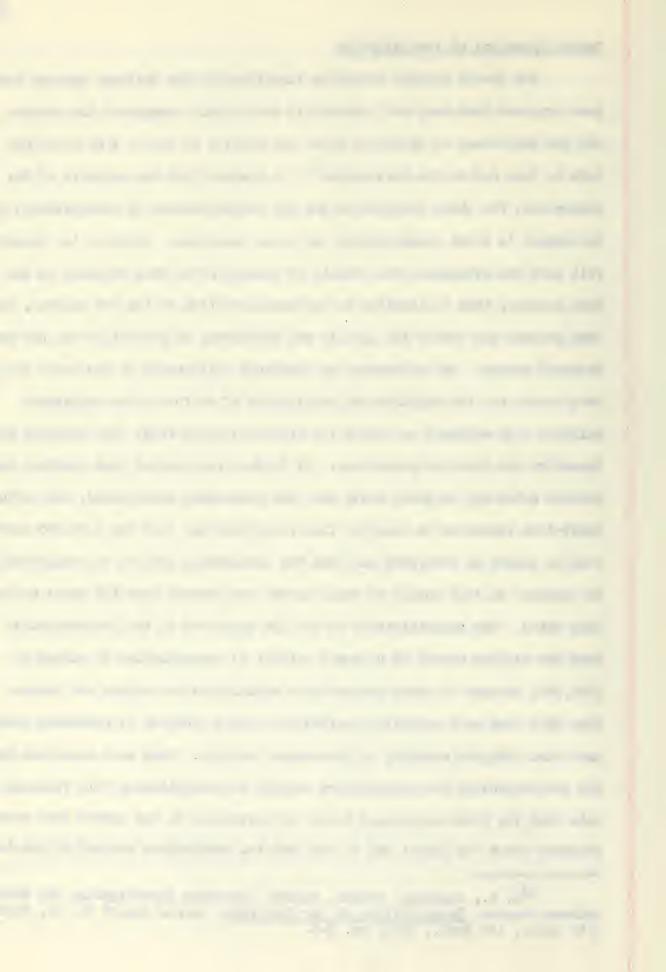
^{12.} S., Congress, House, Committee on Ways and Means, Hearings on H.R. 2324, H.R. 2698, and H.R. 3015, Bills to Amend the Sixth Supplemental National Defense Appropriation Act of 1942, as amended, 78th Cong., 1st Sess., 1943, passim.



Senate Appraisal of Renegotiation

The Senate Special Committee Investigating the National Defense Program reported that many war contractors had already recognized the reasons for and the importance of tailoring their own profits to levels that were fair both to them and to the Government. 13 It praised both the majority of the contractors for their cooperation and the administrators of renegotiation for the manner in which renegotiation was being conducted. However, the Committee felt that the principles and results of renegotiation were shrouded in too much secrecy, that duplication in the administration of the Act existed, and that perhaps the reward for quality and efficiency of production was not being stressed enough. It recommended an immediate unification of the price adjustment boards and the adoption and publication of uniform price adjustment policies with emphasis on reward for efficient production, thus offering an incentive for low-cost production. It further recommended that standard commercial articles, on which costs had been accurately established, and certain short-term contracts be exempted from renegotiation; that the \$100,000 exemption be raised to \$500,000; and that the contractors subject to renegotiation be required to file copies of their income tax returns with the price adjustment board. The administrators of the Act concurred in the recommendation that the minimum amount of accruals subject to renegotiation be raised to \$500,000, because it would reduce their administrative burdens and because they felt that most excessive profits were being realized by producers with more than \$500,000 annually on government business. They also concurred in the recommendation that contractors subject to renegotiation file financial data with the price adjustment boards in preference to the system then being followed where the boards had to seek out the contractors subject to the Act.

¹³U. S., Congress, Senate, Special Committee Investigating the National Defense Program, Renegotiation of War Contracts, Senate Report No. 10, Part 5, 78th Cong., 1st Sess., 1942, pp. 2-4.



The Renegotiation Act of 1943

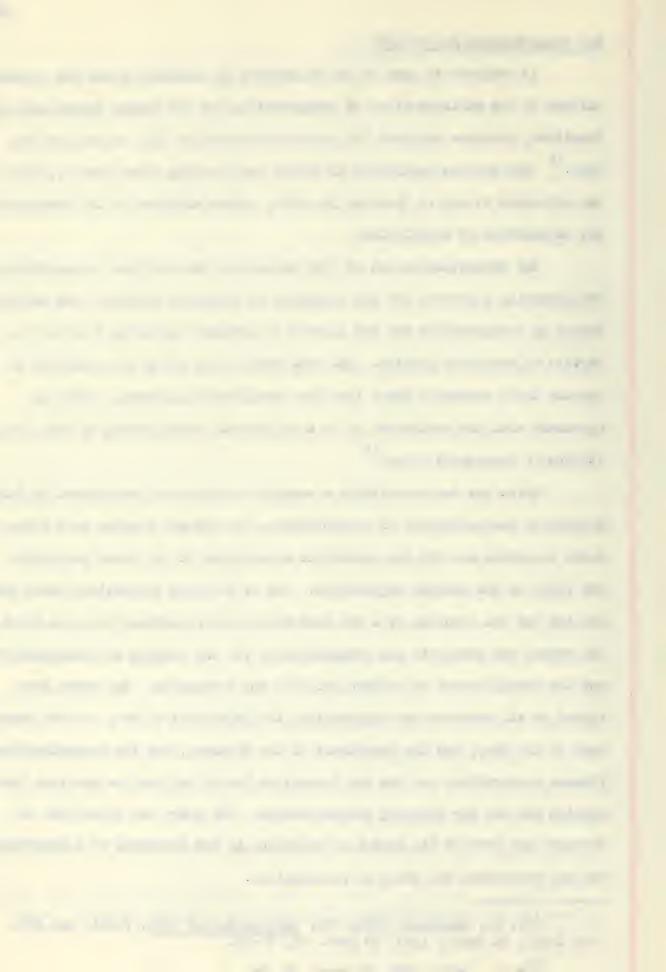
In response to some of the objections by contractors and the recommendations of the administrators of renegotiation and the Senate Investigating Committee, Congress approved the Renegotiation Act of 1943 on February 25, 1944. The Act was applicable to fiscal years ending after June 30, 1943 and was scheduled to expire December 31, 1944, unless extended by the President to the termination of hostilities.

The Renegotiation Act of 1943 emphasized the fact that renegotiation was primarily a process for the recapture of excessive profits. One definite change in renegotiation was the divorce of contract repricing from the recapture of excessive profits. The departments were given the authority to reprice their contracts apart from the renegotiation process, either by agreement with the contractor or by a unilateral determination of what constituted a reasonable price. 15

While the Act constituted a complete revision or restatement of the procedures and principles of renegotiation, the primary changes were procedural in nature and did not constitute alterations of the basic principles set forth in the earlier legislation. One of the main innovations under the new law was the creation of a War Contracts Price Adjustment Board in which was vested the authority and responsibility for the conduct of renegotiation and the establishment of uniform policies and procedures. The Board consisted of six members—one representing the Department of War, one the Department of the Navy, one the Department of the Treasury, one the Reconstruction Finance Corporation, one the War Production Board, and one the Maritime Commission and the War Shipping Administration. The Board was authorized to delegate any part of its powers or functions to the Secretary of a Department who was authorized the power of redelegation.

¹⁴U. S., Congress, Title VII, Revenue Act of 1943, Public Law 235, 78th Cong., 2d Sess., 1943; 58 Stat. 21, 78-92.

¹⁵ Toid., Title VIII, 58 Stat. 21, 92.



The criticism by industry of the arbitrariness of the determination of what constituted excessive profits was answered by providing that the following factors be taken into consideration in the determination of the amount of excessive profits:

- 1. efficiency of contractor, with particular regard to attainment of quality and quantity production, reduction of costs and economy in the use of materials, facilities, and manpower;
- 2. reasonableness of costs and profits, with particular regard to volume of production, normal pre-war earnings, and comparison of war and peacetime products;
- 3. amount and source of public and private capital employed and net worth;
- 4. extent of risk assumed, including risk incident to reasonable pricing policies;
- 5. nature and extent of contribution to the war effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;
- 6. character of business, including complexity of manufacturing techniques, character and extent of subcontracting, and rate of turnover;
- 7. such other factors the consideration of which the public interest and fair and equitable dealing may require, which factors shall be published in the regulations of the Board from time to time.

The Board was required to furnish the contractor with a statement of the facts used as a basis for the determination of excessive profits if the contractor requested it.

The Act provided that any contractor or subcontractor aggrieved by a unilateral determination of excessive profits by the Board could appeal to the Tax Court of the United States for a redetermination. The proceeding before

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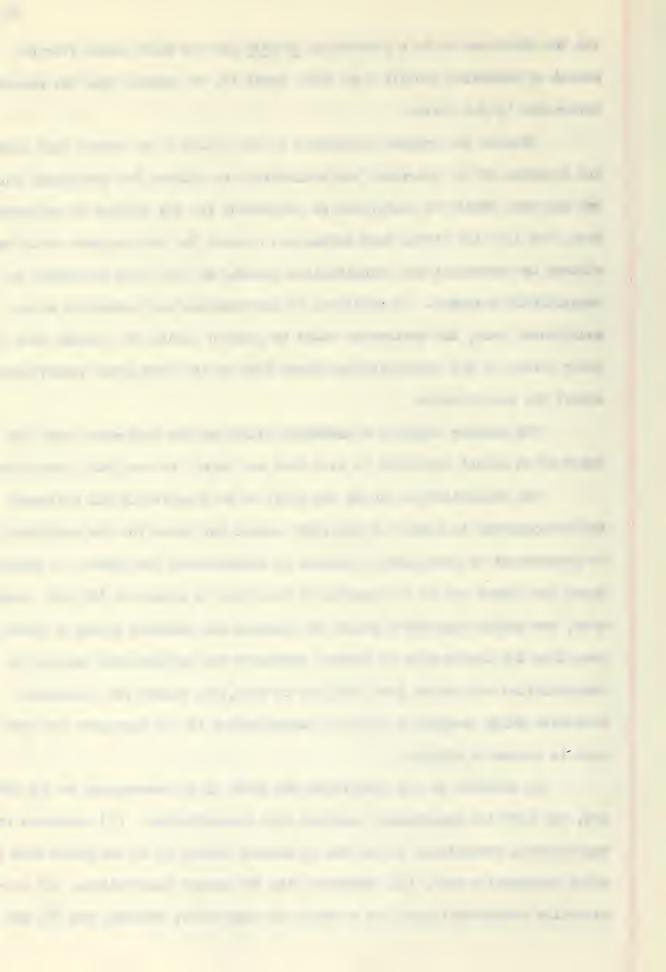
the Tax Court was to be a proceeding de novo and the Court could find an amount of excessive profits less than, equal to, or greater than the amount determined by the Board.

Whereas the earlier amendments to the 1942 Act had stated that costs and expenses of the character the contractor was allowed for deductions for tax purposes should be recognized as deductions for the purpose of renegotiation, the 1943 Act stated that deductions allowed for tax purposes would be allowed as deductions for renegotiation insofar as they were attributed to renegotiable business. In addition, if amortization was recomputed at an accelerated rate, the contractor could be given a rebate for refunds made in prior years, if the recomputation showed that he had been given insufficient credit for emortization.

The statute required a mandatory filing by the contractor with the Board of an annual statement in such form and detail as the Board prescribed.

The renegotiation clause was still to be inserted in all contracts and subcontracts in excess of \$100,000, except for those for the solicitation or procurement of government contracts or subcontracts thereunder, in which cases the clause was to be inserted if they were in excess of \$25,000. However, the minimum aggregate amount of receipts and accruals during a fiscal year from the performance of defense contracts and subcontracts subject to renegotiation was raised from \$100,000 to \$500,000, except for commission contracts which remained subject to renegotiation if the aggregate receipts were in excess of \$25,000.

In addition to the exemptions set forth in the amendments to the 1942 Act, the 1943 Act mandatorily exempted from renegotiation: (1) contracts for agricultural commodities in the raw or natural state, or in the first form in which customarily sold, (2) contracts with tax exempt institutions, (3) construction contracts awarded as a result of competitive bidding, and (4) any

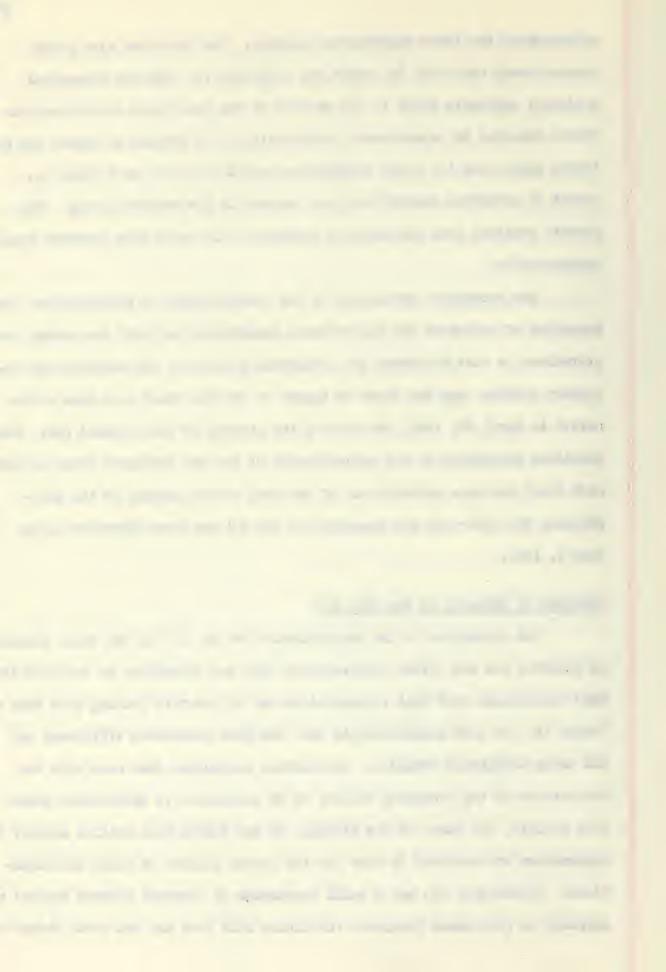


subcontracts for items mandatorily exempted. The Board was also given discretionary authority to exempt any contracts for standard commercial articles; contracts which in the opinion of the Board were not administratively feasible to renegotiate, individually or by classes or types; and contracts which were let under competitive conditions which were likely to result in effective competition with respect to the contract price. The profits realized from increases in inventory value were also exempted from renegotiation.

The emendments pertaining to the recomputation of amortization, the exemption of contracts for agircultural commodities and with tax exempt institutions, a cost allowance for integrated producers, the exclusion of inventory profits, and the right of appeal to the Tax Court were made retroactive to April 28, 1942, the date of the passage of the original Act. The provision pertaining to the establishment of the War Contracts Price Adjustment Board was made effective as of the date of the passage of the Act—February 25, 1944—and the remainder of the Act was made effective as of July 1, 1943.

Reaction of Industry to the 1943 Act

The objections to the Renegotiation Act of 1943 by the vocal elements in industry did not differ substantially from the objections to the 1942 Act. Some businessmen felt that renegotiation was in practice nothing more than a "super 100 per cent excess-profits tax" and that production efficiency was not being adequately rewarded. Contractors maintained that even with the delineation of the statutory factors to be considered in determining excessive profits, the bases of the findings of the boards were still a mystery to contractors who deserved to know how the boards arrived at their determinations. Contractors who had a small percentage of invested private capital as compared to government furnished facilities felt that the net worth factor was



overemphasized, and the contractors who had large amounts of private capital felt that net worth was underemphasized by the boards in arriving at their determinations of reasonable profits. Some felt that greater consideration should have been given to turnover when evaluating the performance of a highly integrated contractor who had a large operating investment and a low rate of turnover. Industrial groups were still attempting to obtain special concessions for their industries.

Extensions of the Act

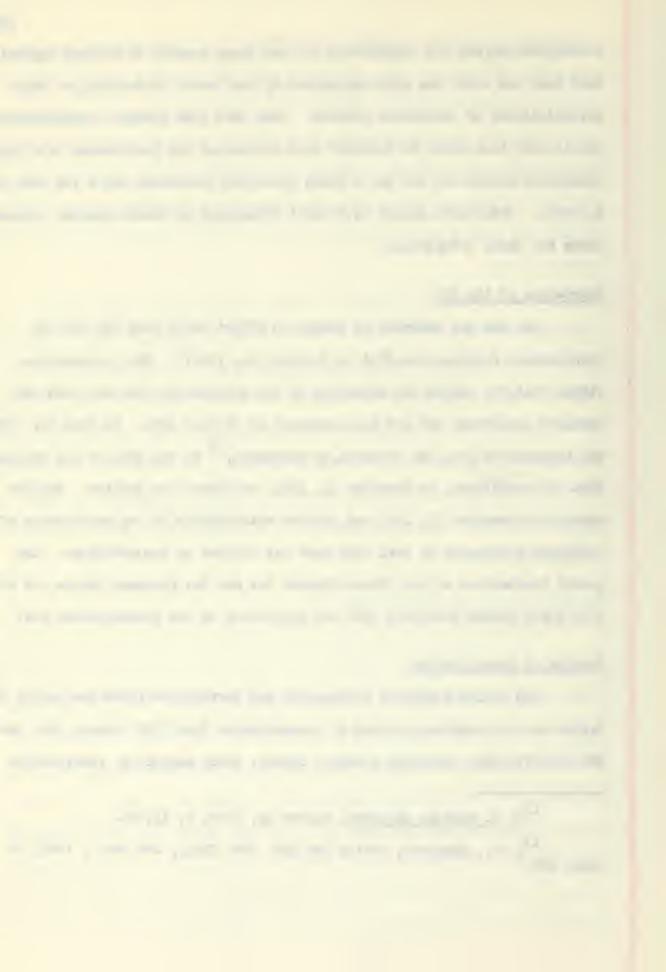
The Act was extended to remain in effect until June 30, 1945 by
Presidential Proclamation 2631 on November 14, 1944. 16 The proclamation
stated that the reason for extension of the termination date was that competitive conditions had not been restored as of that date. On June 30, 1945
the termination date was extended, by amondment, 17 to the date of the termination of hostilities, or December 31, 1945, whichever was earlier. The Act
expired on December 31, 1945 and profits attributable to the performance of
contracts subsequent to that date were not subject to renegotiation. The
profit limitations of the Vinson-Tranmel Act and the Merchant Marine Act of
1936 again became effective with the expiration of the Renegotiation Act.

Results of Renegotiation

The dollar amount of fixed-price and cost-plus-a-fixed-fee supply contracts for corporations subject to renegotiation from 1942 through 1945 was \$223,443,777,000, excluding brokers, agents, sales engineers, construction

¹⁶ U. S. Federal Register, Volume IX, 1944, p. 13,739.

¹⁷U. S., Congress, Public Law 104, 79th Cong., 1st Sess., 1945; 59 Stat. 294.

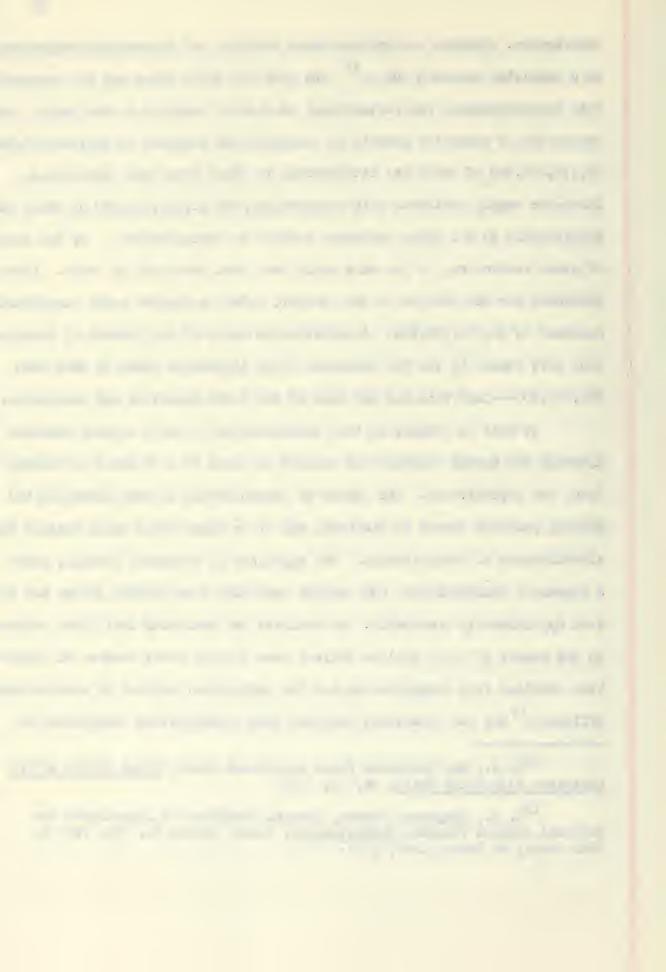


contractors, shipping contractors under charter, and contractors renegotiated on a completed contract basis. ¹⁸ The data for these items and for contracts with proprietorships and partnerships were never compiled by the Board. Gross recoveries of excessive profits by renegotiation amounted to \$11,026,641,000, \$9,770,124,000 of which was attributable to fixed price and cost-plus-a-fixed-fee supply contracts with corporations, and \$1,256,517,000 of which was attributable to all other contracts subject to renegotiation. Of the amount of gross recoveries, 55 per cent would have been recovered by taxes. After allowance for tax credits in this amount, total recoveries under renegotiation amounted to \$4,851,722,040. Administrative costs of the conduct of renegotiation were stated by the War Contracts Price Adjustment Board to have been \$41,476,000—less than one per cent of the total amount of net recoveries.

Although the amount recovered in dollars is great it is a small percentage of total war expenditures. The impact of renegotiation on cost reduction and pricing policies cannot be measured, and it is these items which measure the effectiveness of renegotiation. The aggregate of voluntary refunds, prior to a company's renegotiation, and savings resulting from reduced prices are not even approximately measurable. An estimate has been made that price reductions in the amount of 4-1/2 billion dollars were brought about because of information obtained from renegotiation and the independent actions of contracting officials. 19 The War Department reported that renegotiation contributed to

¹⁸ U. S., War Contracts Price Adjustment Board, Final Report of War Contracts Adjustment Board, May 22, 1951.

¹⁹U. S., Congress, Senate, Special Committee to Investigate the National Defense Program, Renegotiation, Senate Report No. 440, Part 2, 80th Cong., 2d Sess., 1948, p. 4.



resisting the inflationary trend and had a tendency to control the pricing policies of contractors. On the impact of renegotiation is given in one of the Truman Committee reports:

One illustration of such a company is one of our largest aircraft builders (United Aircraft Corporation of East Hartford, Conn.),
whose management have taken the attitude that they do not wish to
profit inordinately from the tremendously increased volume of war
business. The result is that the executives of that company have
come into the Price Adjustment Board periodically every few months
and have submitted the figures on their operations for the few months
immediately preceding, together with an offer of a voluntary refund
of such part of their profits as were deemed excessive. The refunds
made in this manner by this one corporation during the years 1941,
1942, and 1943 have aggregated more than \$206,000,000.

No corporate executive could afford to make a voluntary refund of \$286,000,000 to the Government if he knew that his competitor would be permitted to keep comparable profits with which to ruin him when real competition is restored at the end of the war.

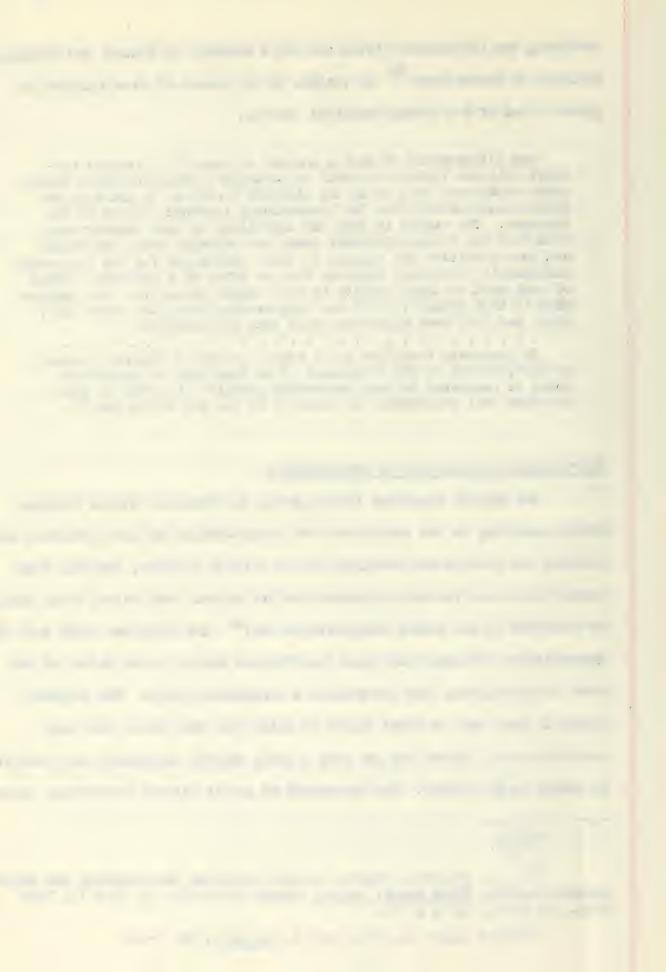
Shortcomings of World War II Renegotiation

The Special Committee Investigating the National Defense Program, while concurring in the conclusion that renegotiation had been effective in limiting war profits and obtaining better pricing policies, reported that renegotiation and its administration had had several weak points which should be rectified in any future renegotiation law. The Committee found that the renegotiation officials had given insufficient weight to the factor of net worth in considering what constituted a reasonable profit. The emphasis seemed to have been on total volume of sales with the result that many companies which started the war with a small capital investment were permitted to retain large profits. The percentage of profit allowed contractors varied

²⁰ Ibid.

²¹ U. S., Congress, Senate, Special Committee Investigating the National Defense Program, Third Annual Report, Senate Report No. 10, Part 16, 78th Cong., 2d Sess., 1944, p. 45.

²² Senate Report No. 440, Part 2, op. cit., pp. 7-12.



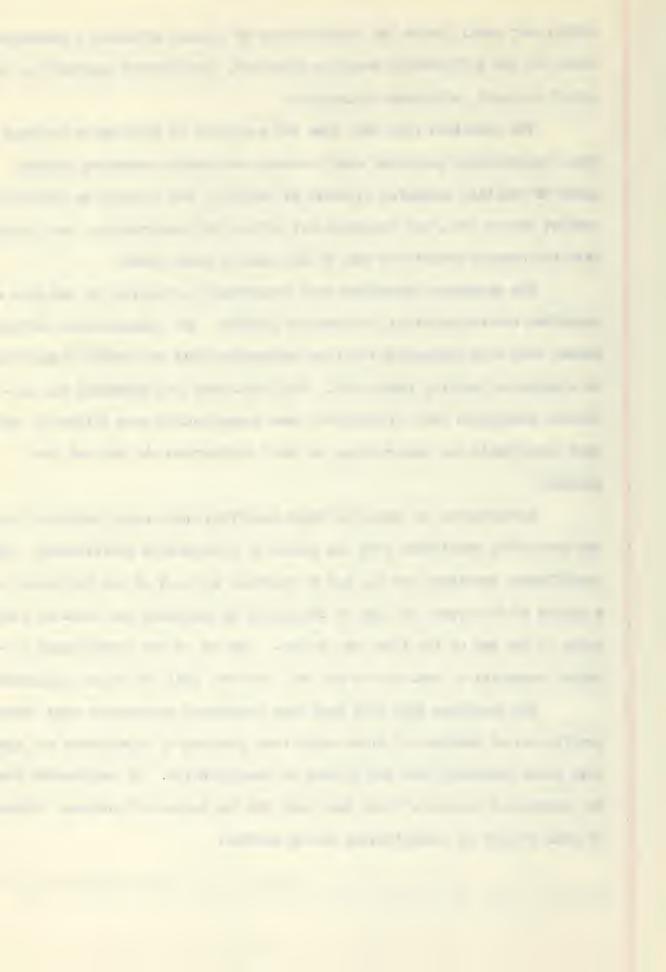
within very small limits for manufacturers of similar articles, a practice which did not sufficiently penalize high-cost, ineff idient contractors, or reward low-cost, efficient contractors.

The Committee also felt that the exemption of \$500,000 of business from renegotiation permitted small concerns to realize excessive profits. A group of thirteen companies selected at random in the \$100,000 to \$500,000 bracket during 1943, and therefore not subject to renegotiation, were found to have had average profits of over 38 per cent of gross sales.

The mandatory exemptions from renegotiation specified in the Acts also permitted the accumulation of excessive profits. The renegotiation officials agreed with this impression and also recommended that permissive exemptions be eliminated from any future Act. They felt that both mandatory and permissive exemptions were unjustified, made renegotiation more difficult, and were unequitable and demoralizing to other contractors who had not been exempted.

Certificates of necessity which permitted rapid amortization of new war production facilities were one source of considerable profiteering. The certificates permitted the holders to amortize the cost of the facilities over a period of five years or less if the period of emergency was declared over prior to the end of the five year period. The use of the certificates permitted companies to come out of the war with new, fully amortized equipment.

The Committee also felt that some government contractors made large profits out of defense-end items which were procured by departments and agencies whose contracts were not subject to renegotiation. It recommended that all government contracts which were made for the purpose of national defense be made subject to renegotiation during wartime.



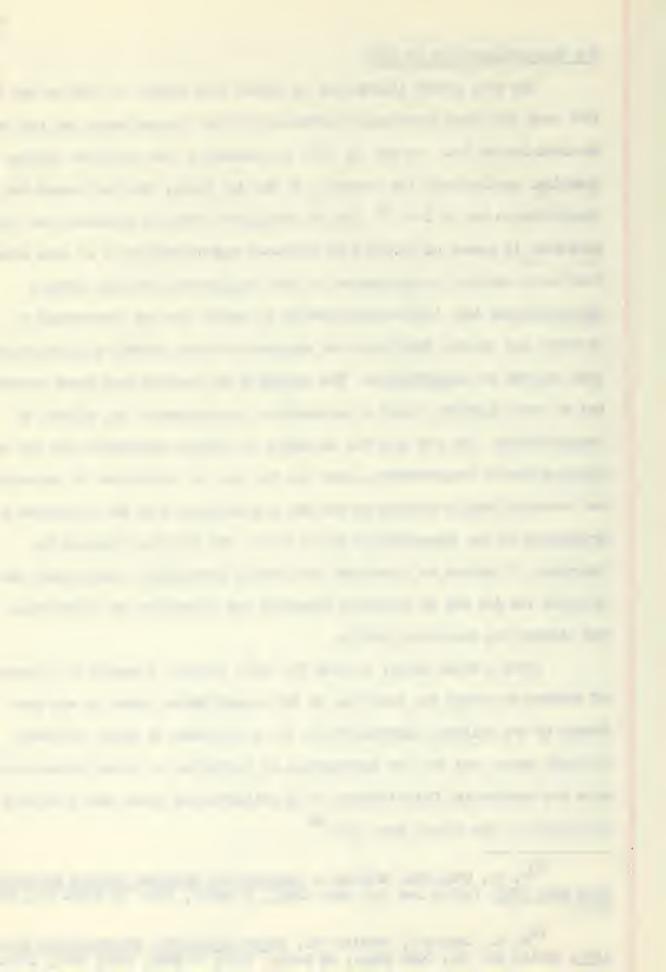
The Renegotiation Act of 1948

The only profit limitations in effect from January 1, 1946 to May 21, 1948 were the fixed percentage limitations of the Vinson-Trammel Act and the Merchant Marine Act. On May 21, 1948 in connection with increased defense spending, particularly the expansion of the Air Force, Congress passed the Renegotiation Act of 1948. 23 The Act stipulated that all contracts and subcontracts in excess of \$1,000 that obligated appropriations of or were entered into under contract authorizations of the Supplemental National Defense Appropriations Act, 1948 appropriations primarily for the procurement of aircraft and related facilities and equipment -- should contain a clause making them subject to renegotiation. The aggregate of receipts from these contracts had to total \$100,000 before a contractor or subcontractor was subject to renegotiation. The Act made the Secretary of Defense responsible for the administration of renegotiation, gave him the power of delegation of authority, and directed that he administer the Act in accordance with the procedures and provisions of the Renegotiation Act of 1943. The Act also directed the Secretary of Defense to promulgate and publish regulations interpreting and applying the Act and to prescribe standards and procedures for determining and eliminating excessive profits.

About a month later, on June 25, 1948, Congress directed the Secretary of Defense to direct the insertion of the renegotiation clause in any contracts of the military departments for the procurement of ships, aircraft, aircraft parts, and for the construction of facilities or installations outside the continental United States which obligated any funds made available for obligation in the fiscal year 1949.

²³U. S., Congress, Section 3, Supplemental National Defense Appropriation Act, 1948, Public Law 547, 80th Cong., 2d Sess., 1948; 62 Stat. 258, 259-261.

²⁴U. S., Congress, Section 401, Second Deficiency Appropriation Act, 1948, Public Law 785, 80th Cong., 2d Sess., 1948; 62 Stat. 1027; 1049, 1050.



Subsequent appropriation Acts made the Renegotiation Act of 1948 applicable to all negotiated contracts, and subcontracts thereunder, which obligated funds during the years 1950²⁵ and 1951.

²⁵U. S., Congress, Section 622, National Military Establishment Appropriation Act, 1950, Public Law 434, 81st Cong., 1st Sess., 1949; 63 Stat. 987, 1021.

²⁶U. S., Congress, Section 618, Chapter X, Defense Appropriation Act, 1951, General Appropriation Act 1951, Public Law 759, Clat Cong., 2d Sess., 1950; 64 Stat. 595, 730, 754.



CHAPTER III

THE RENEGOTIATION ACT OF 1951

The Basic Act

In response to the increase in defense spending occasioned by the outbreak of the Korean War in June 1950, the House Committee on Ways and Means began holding hearings in August 1950 on a bill, introduced by Representative Carl Vinson, to provide for extension of renegotiations to cover all defense contracts. Representative Vinson stated that in his opinion the partial applicability of the 1948 Act was not sufficient or broad enough to prevent the realization of excessive profits or to hold prices down. Subsequent to unanimous approval of the bill by the House, and public hearings by the Senate Committee on Finance in January 1951, Congress enacted the Renegotiation Act of 1951 on March 27, 1951.

The Act for the first time set forth the policy on which a renegotiation Act was based. Section 101 of the Act states:

It is hereby recognized and declared that the Congress has made available for the execution of the national defense program extensive funds, by appropriation and otherwise, for the procurement of property, processes, and services, and for the construction

U. S., Congress, House, Committee on Ways and Means, Hearings on H.R. 9246, A Bill to Provide for the Renegotiation of Contracts, and for Other Purposes, 81st Cong., 2d Sess, 1950.

²U. S., Congress, Senate, Committee on Finance, Hearings on H.R. 1724, An Act to Provide for the Renegotiation of Contracts, and for Other Purposes, 82d. Cong., 1st Sess., 1951.

³u. S. Congress, Public Law 9, 82d. Cong., 1st Sess., 1951; 65 Stat.7.

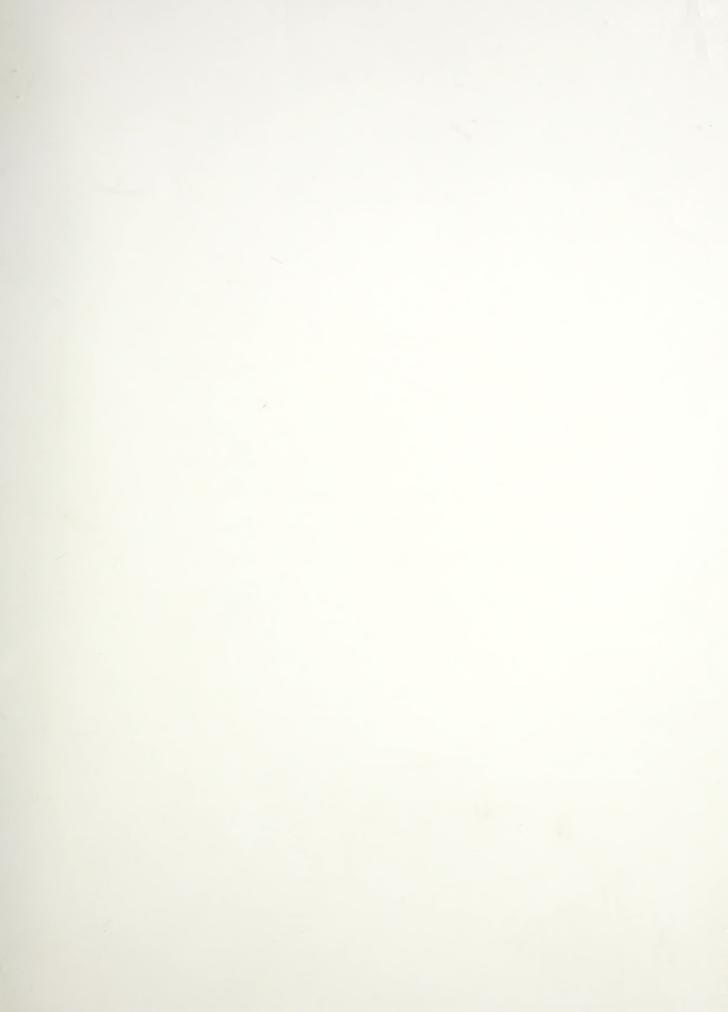
of facilities necessary for the national defense; that sound execution of the national defense program requires the elimination of excessive profits from contracts made with the United States, and from related subcontracts, in the course of said program; and that the considered policy of the Congress, in the interests of national defense and the general welfare of the nation, requires that such excessive profits be eliminated as provided in this title.

The Act was made effective as of January 1, 1951 and all amounts received or accrued from the performance of the contracts designated in the Act were subject to the provisions of the Act. It also made provision for the completion of uncompleted 1948 Act proceedings by the new Board established by the Act. The termination date of the Act was December 31, 1953.

The Act, with a few changes, was based almost entirely on the 1943 Act, as amended. The agencies whose contracts, and subcontracts thereunder, were subject to renegotiation under the basic Act were the Department of Defense; the Departments of the Army, Navy, and Air Force; the Department of Commerce; the General Services Administration; the Atomic Energy Commission; the Reconstruction Finance Corporation; the Canal Zone Government; the Panama Canal Company; the Housing and Home Finance Agency; and such other agencies of the Government exercising functions having a direct and immediate connection with the national defense as the President desired to designate. Excessive profits were to be determined with respect to the amounts received or accrued by a contractor under renegotiable contracts or subcontracts in an entire fiscal year of the contractor. The renegotiable floor (i.e., the minimum aggregate of receipts or accruals by a contractor during a fiscal year) was set at \$250,000, except for subcontractors whose compensation was received in the form of commissions—agents, brokers, etc.—for whom the floor was set at \$25,000. The statutory factors to be considered in the determination of excessive profits, although worded slightly differently, were the same as those set forth in the 1943 Act. 4 All deductions allowed for Federal income tax

⁴ Supra, p. 34.







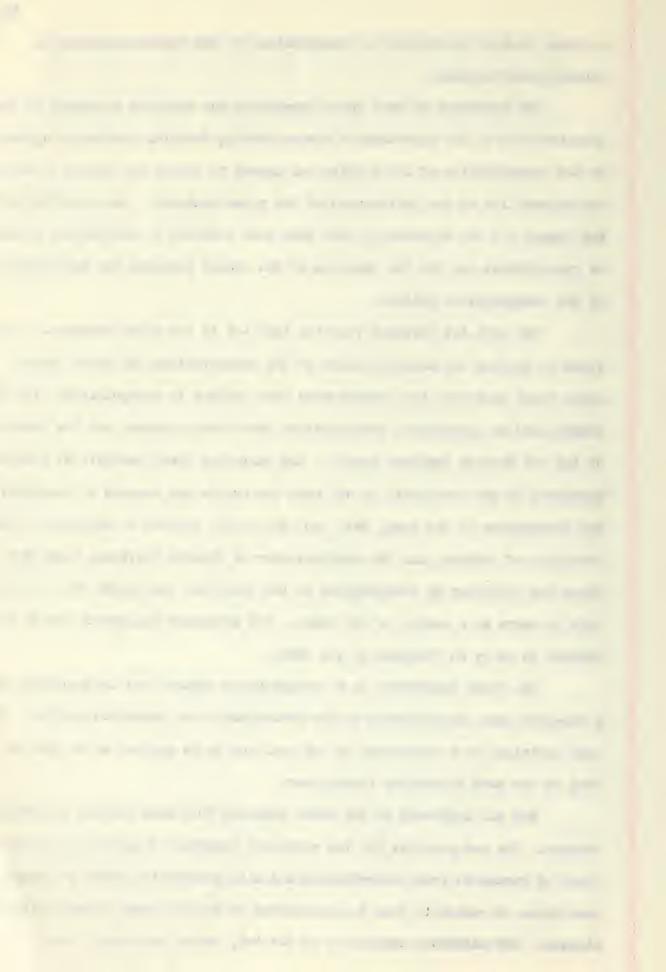
purposes were to be allowed in renegotiation to the extent allocable to renegotiable business.

The Secretary of each named department was directed to insert in each contract made by his department a clause stating that the contractor agreed to the renegotiation of his profits and agreed to insert the clause in each subcontract let in the performance of the prime contract. The insertion of the clause did not necessarily mean that such contract or subcontract would be renegotiated nor did the omission of the clause preclude the applicability of the renegotiation statute.

The 1951 Act differed from the 1943 Act in two major respects. Instead of putting the administration of the Renegotiation Act under departments whose contracts and subcontracts were subject to renegotiation, the Act established an independent Renegotiation Board which carries out the provisions of the Act through Regional Boards. The Statutory Board consists of five men appointed by the President, by and with the advice and consent of the Senate. The Secretaries of the Army, Navy, and Air Force, subject to approval of the Secretary of Defense, and the Administrator of General Services, were each given the privilege of recommending to the President one person from civilian life to serve as a member of the Board. The President designates one of the members to serve as Chairman of the Board.

The other innovation in a renegotiation statute was the provision for a one-year loss carry-forward in the determination of excessive profits. A loss sustained by a contractor in one year was to be applied as an item of cost in the next succeeding fiscal year.

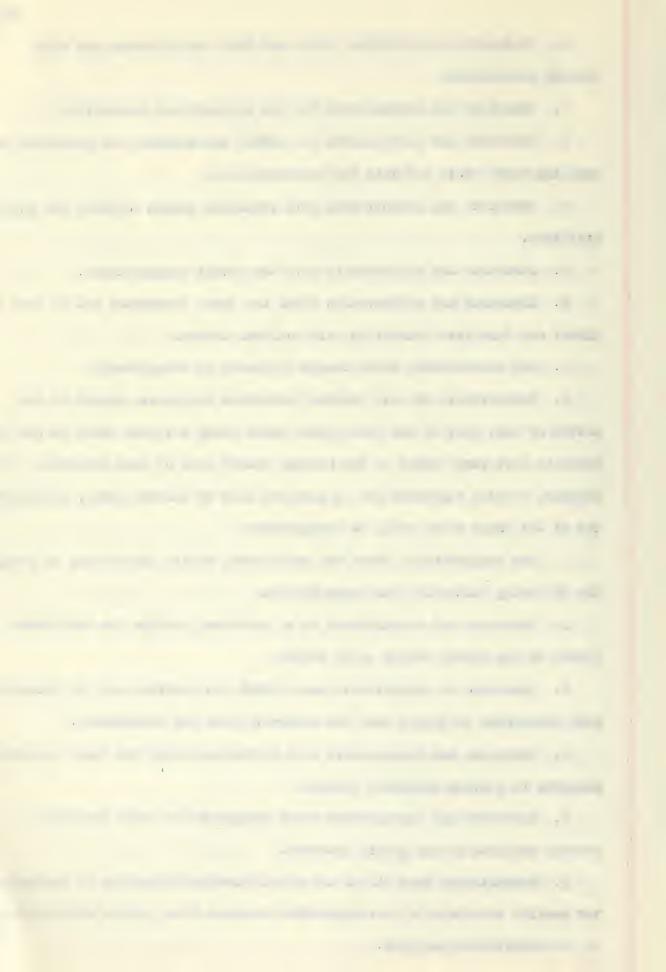
Not all contracts of the named agencies were made subject to renegotiation. The Act provides for the statutory mandatory exemption of certain types of contracts from renegotiation and also permits the Board to exempt some types of contracts from the provisions of the Act under certain circumstances. The mandatory exemptions in the Act, before amendment, were:



- 1. Contracts with political units and their subdivisions and with foreign governments.
 - 2. Contracts and subcontracts for raw agricultural commodities.
- 3. Contracts and subcontracts for timber and minerals not processed be-
- 4. Contracts and subcontracts with regulated common carriers and public utilities.
 - 5. Contracts and subcontracts with tex-exempt organizations.
- 6. Contracts and subcontracts which the Board determined not to have a direct and immediate connection with national defense.
 - 7. Any subcontracts under exempt contracts or subcontracts.
- 8. Subcontracts for new durable productive equipment, except to the extent of that part of the sales price which bears the same ratio to the total price as five years bears to the average useful life of such equipment. For example, if such equipment has an expected life of fifteen years, five-fifteenths of the sales price would be renegotiable.

The Renegotiation Board was authorized, at its discretion, to exempt the following contracts from renegotiation:

- 1. Contracts and subcontracts to be performed outside the continental limits of the United States or in Alaska.
- 2. Contracts or subcontracts under which the profits could be determined with reasonable certainty when the contract price was established.
- 3. Contracts and subcontracts with provisions which the Board considered adequate to prevent excessive profits.
- 4. Contracts and subcontracts whose renegotiation would jeopardize secrecy required in the public interest.
- 5. Subcontracts when it was not administratively feasible to segregate the profits attributable to renegotiable business from profits attributable to nonrenegotiable business.



As in the 1943 Act, contractors aggrieved by an order of the Board may file a petition with the Tax Court of the United States for a redetermination in a proceeding do nove. The determination of the Tax Court of the amount of excessive profits, if any, is final.

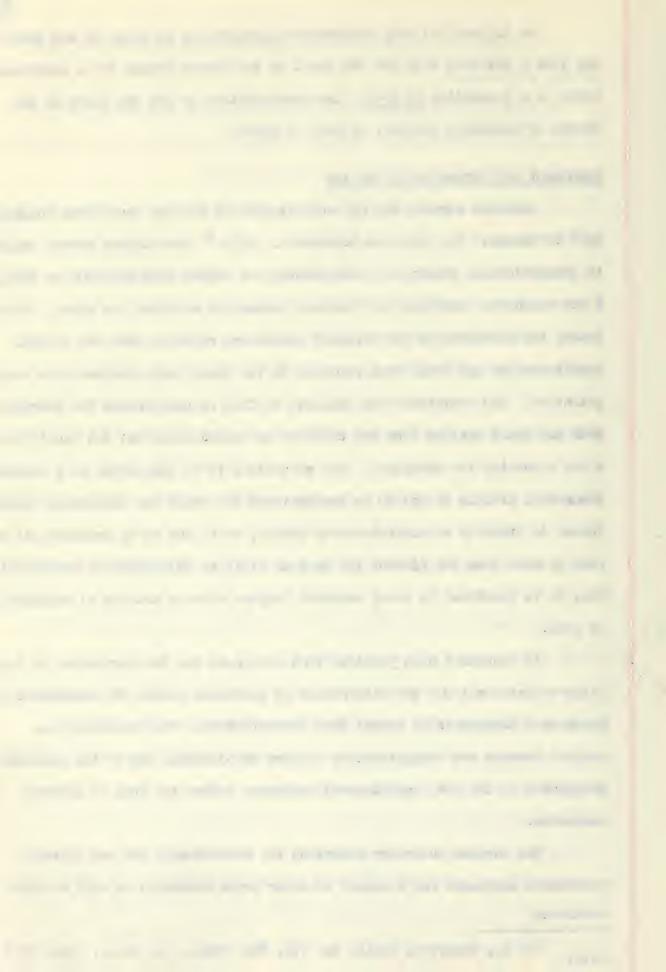
Amendment and Extension of the Act

Congress emended the Act and extended it for one year—from January 1, 1954 to December 31, 1954—on September 1, 1954.5 The minimum amount subject to renegotiation, except for commissions, was raised from \$250,000 to \$500,000. A new mandatory exemption for standard commercial articles was added. Contracts and subcontracts for standard commercial articles that met certain qualifications and which were approved by the Board were exempted from renegotiation. The contractor was required to file an application for exemption with the Board stating that the articles he manufactured met the qualifications necessary for exemption. For an article to be classified as a standard commercial article it had to be manufactured for stock and customarily maintained in stock by a manufacturer or dealer, or it had to be manufactured and sold by more than two persons for general civilian industrial or commercial use, or be identical in every material respect with an article so manufactured or sold.

An amendment also provided that contracts for the furnishing of supplies or materials for the manufacture of synthetic rubber for nondefense purposes were mandatorially exempt from renegotiation. This amendment was adopted because the Reconstruction Finance Corporation, one of the agencies designated in the Act, manufactured synthetic rubber for sale to private companies.

The partial mandatory exemption for subcontracts for new durable productive equipment was extended to cover prime contracts as well as subcontracts.

^{50.} S., Congress, Public Law 764, 83d Cong., 2d Sess., 1954; 68 Stat.



On August 3, 1955 the Act was amended and extended until December 31, 1956. The exemption that applied to contracts for standard commercial articles was extended to cover contracts for standard commercial services. To be eligible for the standard commercial service exemption, a service had to be one that was customarily performed by more than two persons for general civilian industrial or commercial requirements or was reasonably comparable with a service so performed. Application for exemption had to be made to the Board in the same manner as application for standard commercial article exemption.

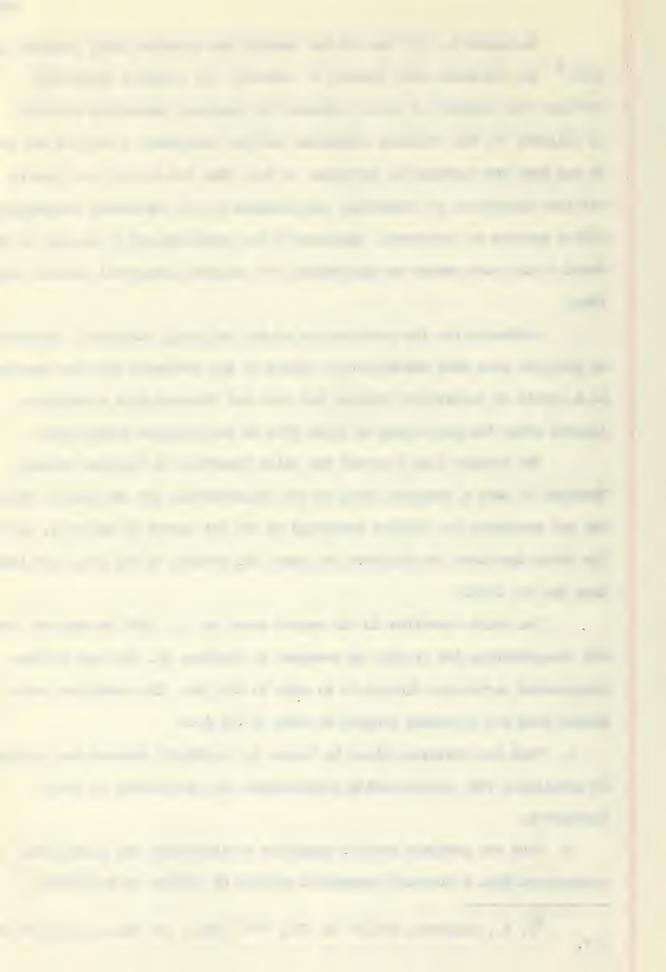
Contracts for the construction of any building, structure, improvement, or facility were made mandatorially exempt if the contracts had been awarded as a result of competitive bidding and were not financed with a mortgage insured under the provisions of Title VIII of the National Housing Act.

The statute also directed the Joint Committee on Internal Revenue
Taxation to make a complete study of the Renegotiation Act and whether there
was any necessity for further extension of the Act beyond December 31, 1956.
The Joint Committee was directed to report the results of the study not later
than May 31, 1956.

The Joint Committee in its report dated May 31, 1956 recommended that the Renegotiation Act of 1951 be extended to December 31, 1951 and further recommended particular changes to be made in the law. The Committee recommended that the following changes be made to the Act:

- 1. That the statutory floor be raised to \$1,000,000 because the problems of compliance with renegotiation requirements were burdensome to small businesses.
- 2. That the standard article exemption be simplified and classified. It recommended that a standard commercial article be defined as an article

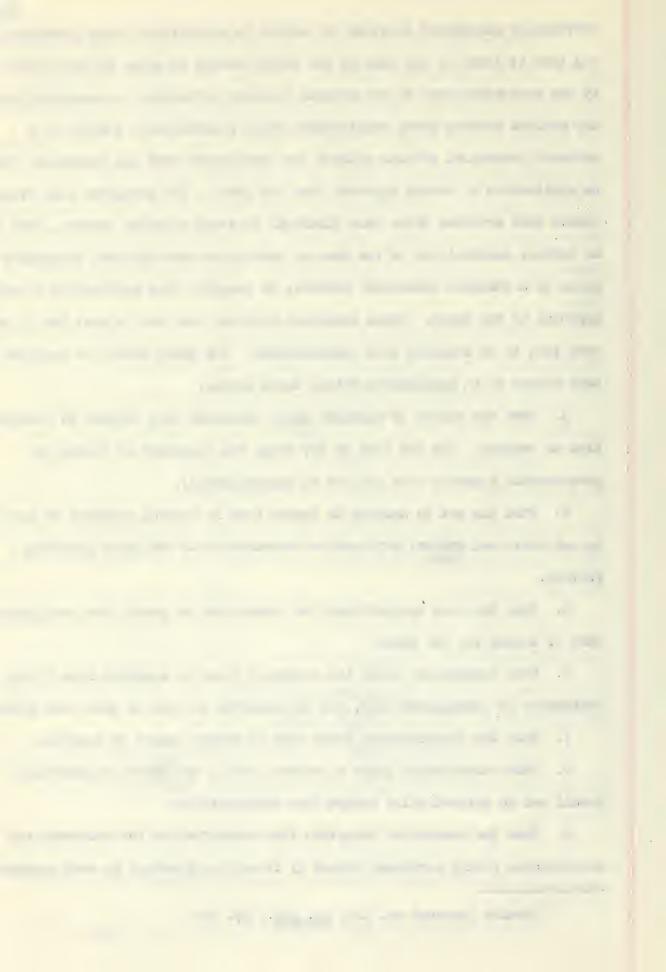
⁶U. S., Congress, Public Law 216, 84th Cong., 1st Sess., 1955; 69 Stat.



customarily maintained in stock or covered by established price quotations, and that at least 35 per cent of the dollar amount of sales of such articles by the contractor must be for general civilian industrial or commercial use. Any article meeting these requirements would sutomatically qualify as a standard commercial article without the requirement that the contractor file an application or obtain approval from the Board. The Committee also recommended that articles which were identical in every material respect, that is, an article manufactured of the same or substitute materials and comparable in price to a standard commercial article, be exempted upon application to and approval by the Board. These identical articles also had to meet the 35 per cent test to be exempted from renegotiation. The Board should be required to take action on an application within three months.

- 3. That the number of agencies whose contracts were subject to renegotiation be reduced. [At the time of the study the contracts of twenty-one governmental agencies were subject to renegotiation].
- 4. That the act be amended to insure that no special emphasis be given to net worth and capital employed as contrasted with the other statutory factors.
- 5. That the loss carry-forward be liberalized to permit the carrying-forward of losses for two years.
- 6. That contractors below the statutory floor be exempted from filing statements of nonapplicability, but be permitted to file at their own option.
 - 7. That the Renegotiation Board make an annual report to Congress.
- 8. That subcontracts under a contract with a tax-exempt organization should not be automatically exempt from renegotiation.
- 9. That the permissive exemption from renegotiation for contracts and subcontracts wholly performed abroad by foreign contractors be made mandatory.

Senate Document No. 126, op. cit., pp. 2-4.



On August 1, 1956 the Act was amended and extended until December 31, 1958. All of the recommendations of the Joint Committee on Internal Revenue Texation were adopted except the one relating to contracts performed abroad. The agencies whose contracts and subcontracts were now subject to renegotiation were restricted to the Department of Defense; the Departments of the Army, Navy, and Air Force; the Maritime Administration; the Federal Maritime Board; the General Services Administration; and the Atomic Energy Commission. The President is permitted to include any other agency of the Government exercising functions having a direct and immediate connection with the national defense only during a national emergency proclaimed by the President or declared by Congress.

The Amendments Act also provided that a contractor could appeal a decision of the Tax Court, to the extent subject to review, to the United States Court of Appeals for the circuit in which is located the office to which a contractor made his Federal income-tax return. A decision from the Tax Court can only be appealed on constitutional or jurisdictional grounds.

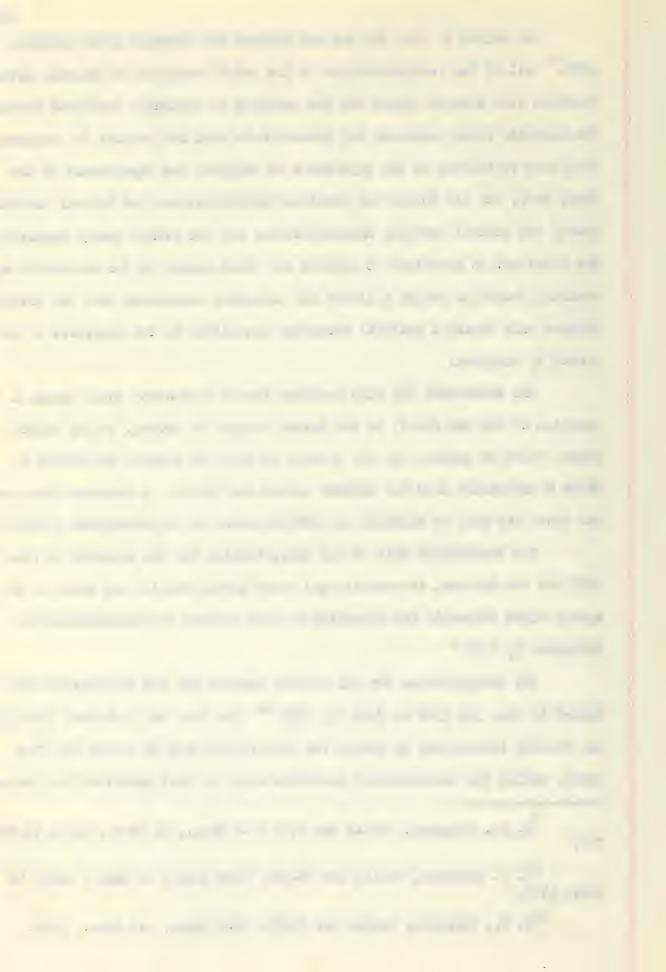
The termination date of the Renegotiation Act was extended to June 30, 1959 and the National Aeronautics and Space Administration was added as an agency whose contracts and subcontracts were subject to renegotiation on September 6, 1958.

The Renegotiation Act was further amended and the termination date extended to June 30, 1962 on July 13, 1959. The loss carry-forward provision was further liberalized to permit the carrying-forward of losses for five years, making the carry-forward provision equal to that permitted for Federal

⁸U. S., Congress, Public Law 870, 84th Cong., 2d Sess., 1956; 70 Stat. 786.

⁹U. S. Congress, Public Law 85-930, 85th Cong., 2d Sess., 1958; 72 Stat. 1789.

^{10.} S., Congress, Public Law 86-89, 86th Cong., 1st Sess., 1959.

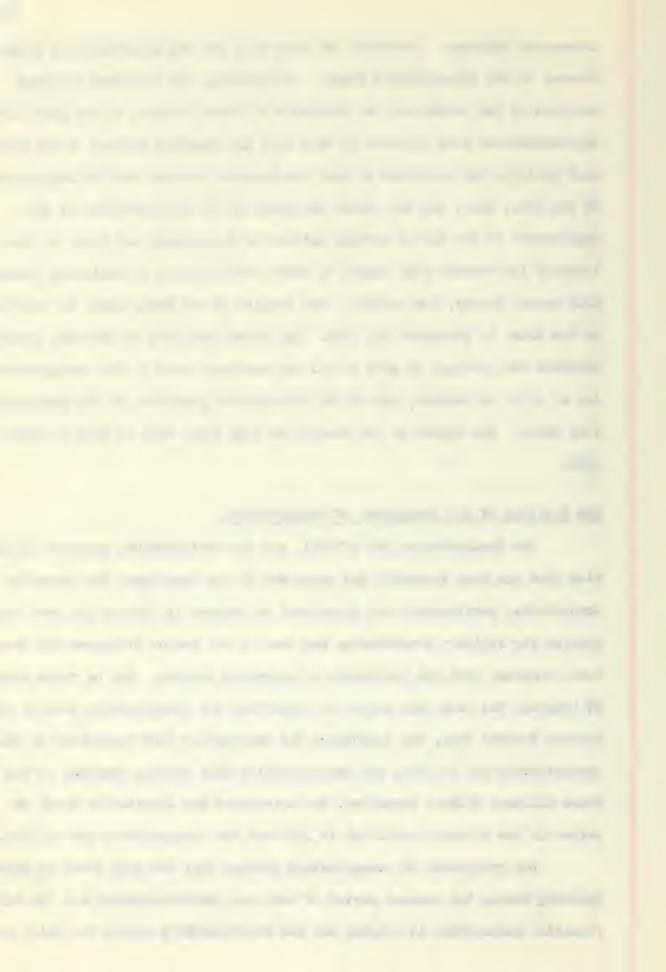


income-tax purposes. Provision was also made for the appointment of a General Counsel of the Renegotiation Board. In addition, the Committee on Armed Services of the House of Representatives were directed to make full and complete studies of the procurement policies and practices of the Department of Defense and the Departments of the Army, Navy, and Air Force, particularly of the experience of the departments in the use of various methods of procurement and types of contractual instruments with regard to their effectiveness in achieving reasonable costs, prices, and profits. The results of the study shall be reported to the House by September 30, 1960. The Joint Committee on Internal Revenue Taxation was directed to make a full and complete study of the Renegotiation Act of 1951, as amended, and of the policies and practices of the Renegotiation Board. The report on the results of this study will be made by March 31, 1961.

The Position of the Proponents of Renegotiation

The Renegotiation Act of 1951, and its continuation, comprise legislation that has been requested and supported by the President, the executive departments, particularly the Department of Defense in view of the vast expenditures for military procurement, and some of our senior statesmen who have been concerned with the prevention of excessive profits. Two of these members of Congress who have been active in supporting the renegotiation statute are Senator Francis Case, who introduced the legislation that culminated in the Renegotiation Act of 1942, and Representative Carl Vinson, Chairman of the House Military Affairs Committee, who introduced the legislation which resulted in the Vinson-Tranmel Act in 1934 and the Renegotiation Act of 1951.

The proponents of renegotiation contend that the high level of defense spending during the present period of cold war semimobilization and the difficulties encountered in pricing new and experimental products for which no



past production and cost experience is available, make renegotiation necessary to prevent the realization of excessive profits from defense procurement and to hold down the prices of defense materials. This is particularly emphasized in the area of subcontracting where the Defense Department feels that it does not have adequate controls to prevent the realization of excessive profits and inflated prices. Basically, the position of the advocates of renegotiation is that renegotiation is necessary for the following reasons:

- 1. The high level of defense spending for procurement, the greatest portion of which takes place in areas of little or no competition.
- 2. The problem with respect to procurement and pricing in areas of unique and novel military technologies. In these areas it is often impossible for the Government to determine, when a procurement contract is made, what constitutes a fair price and for the supplier to accurately forecast his cost.

 Most contracts for procurement of this type are made with a contractor best qualified to produce the equipment and, because of the limited sources of supply and the experimental nature of the work, the Government is unable to obtain the price benefits that may result from procurement under normally competitive conditions.
- 3. The problem of controlling prices and profits in the area of subcontracts which constitute a large part of the dollar amount of expenditures for defense procurement.
- 4. The mere existence of renegotiation makes for better and closer pricing policies on the part of contractors and subcontractors, because pricing risks are one of the factors considered in the determination of excessive profits.

In testifying before the House Ways and Means Committee in support of the proposed renegotiation legislation in 1950, Representative Carl Vinson, Chairman of the House Armed Services Committee, stated:



In the first place, renegotiation is not a revenue measure
. . . The objective of renegotiation is not to raise revenue,
but to hold prices down.

Because of these facts and circumstances [increased defense spending] I think it is incumbent upon us to provide by a broad coverage of renegotiation an effective means of keeping down excessive prices and profits.

This is the sole purpose of renegotiation—to hold the prices down and not permit excessive profits to be made.ll

In his testimony before the Senate Committee on Finance during hearings on extension of the Renegotiation Act in 1955, Senator Francis Case produced several examples of why renegotiation is necessary. Part of Senator Case's testimony was as follows:

. . . I have obtained a few sample cases which are current under the Act of 1951.

One contractor whom I shall designate as contractor A designed and manufactured electronic connectors and adaptors, largely for aircraft. Renegotiable sales were just under \$2 million but they yielded profits of almost \$1 million or actual 50.5 percent of the business.

This contractor's investment in machinery and equipment was only \$14,000 when he began the year, and was only \$48,000 at the and. Yet on that investment—an investment of \$48,000—by the end of the year he had a profit of \$1 million.

Over 90 percent of the work was subcontracted.

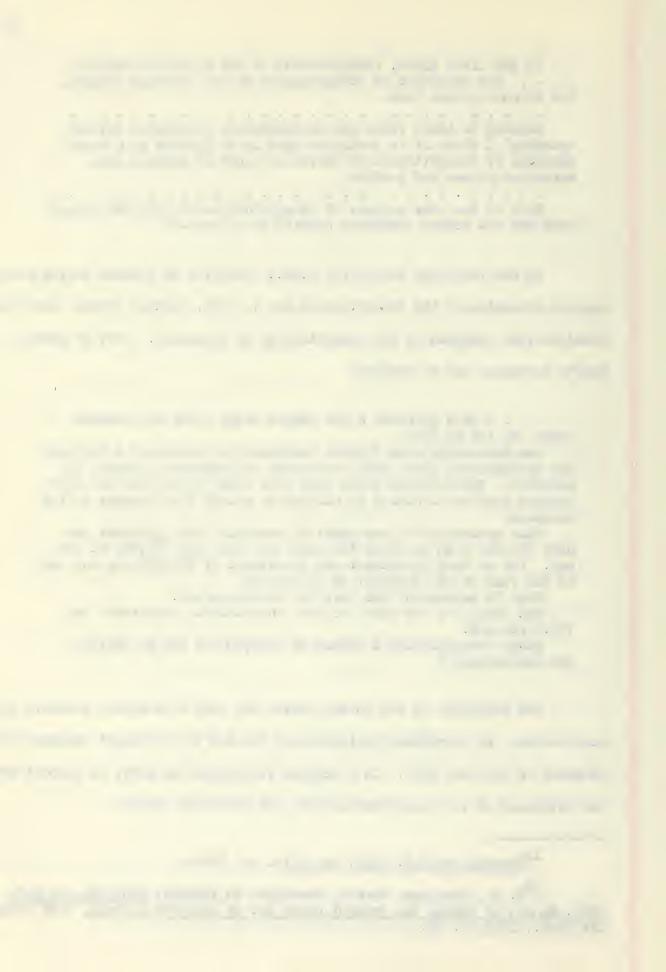
The return on net worth of this manufacturer contractor was 778.9 percent.

Under renegotiation a refund of \$750,000 of the \$1 million was determined. 12

The President of the United States has been a steadfast advocate of rehegotiation. He recommended extension of the Act in his Budget Messages to Congress in 1958 and 1959. In a message to Congress in 1955, in support of the extension of the Renegotiation Act, the President stated:

¹¹ Rearings on H.R. 9246, op. cit., pp. 12-13.

¹²U. S., Congress, Senate, Committee on Finance, Hearings, on H.R. 4904, An Act to Extend the Renegotiation Act of 1951 for 2 years, 84th Cong., 1st Sess., 1955, p. 73.



In spite of major improvements, which we have achieved in our contracting and price redetermination operations, there nevertheless remains an area in which only renegotiation can be effective to assure that the United States gets what it needs for defense at fair prices.

Continuation of the renegotiation authority is necessary for several reasons. Because of the complex nature of modern military equipment, the lack of experience in producing it, and the frequent alterations during the life of a contract, it is impossible for the Government to determine, when the contract is made, what constitutes a fair price and for the supplier to accurately forecast his costs. Moreover, because of limited sources of supply in many cases, there are situations in which the Government is unable to obtain the price benefits that accrue from normal competition.

Furthermore, in the interest of broadening and strengthening the mobilization base, we have encouraged the extensive use of subcontracting. Because the United States has no direct contractual relations with subcontractors, the only protection against unreasonable prices by them is through the process of renegotiation. 13

In a letter to the Speaker of the House supporting and emphasizing the necessity for an extension of the Renegotiation Act in 1959, the Secretary of Defense stated:

Defense expenditures are expected under current world conditions to continue at or somewhat near their present high rate for the foreseeable future. For fiscal year 1959 expenditures of the Department of Defense are estimated to be \$40.8 billion. Approximately one-half of such expenditures represents amounts for the procurement of goods and services which would be subject to the provisions of the Act.

The purpose of renegotiation is to eliminate excessive profits from defense contracts and subcontracts thereunder. In large-scale procurement programs involving the purchase of many different types of specialized items, many of unprecedented nature, past production and cost experience are not always available for accurately forecasting the costs of such items. Today, particularly, we are witnessing rapid developments in the aircraft, missile, and space fields. Pricing policies and contracting techniques of the procuring agencies cannot guarantee in all cases against excessive profits.

Experience has shown that the renegotiation authority is an effective method of preventing excessive profits. It has a salutary effect in contract pricing and has proved particularly effective in the subcontracting areas where maintenance of pricing controls is extremely difficult. 14

¹³ Ibid., letter reproduced on pp. 1-2.

the General Subject of an Extension of the Renegotiation Act, 85th Cong., 1st Sess., 1959, letter reproduced on p. 2.



The Views of Industry on Renegotiation

The reaction of industry to the passage of the Renegotiation Act of 1951 and its subsequent amendments is reminiscent of its reaction to the World War II statute. One change in the type of reaction is that, while most industrial representatives did not advocate outright repeal of the World War II renegotiation law, but rather sought concessions for their particular industry, the majority of the representatives of business as evidenced in congressional hearings on extensions of the 1951 Act advocated outright repeal of the present Renegotiation Act, stating that such controls are not necessary in peacetime and that the present level of defense procurement is not high enough to warrant the continuation of this statute. The National Association of Manufacturers, in response to a questionnaire sent to 250 defense contractors in 1958 on the subject of renegotiation, received replies that showed that the contractors were overwhelmingly opposed to renegotistion. 15 However. it must be kept in mind that those in industry who support the continuation of renegotiation would probably not testify at congressional hearings to make their approval known. That some industry representatives do support renegotiation is evidenced by a statement of the Business Committee on National Policy of the National Planning Association, an independent, nonpolitical, monprofit organization composed of representatives from agriculture, business. government, labor, and the professions, issued in 1950 in which the Association strongly recommended enactment of adequate renegotiation legislation. 16

Some of the more common of the arguments against the continuation of renegotiation proposed by industrial spokesmen and a short discussion of each are as follows:

¹⁵ Thid., pp. 328-330.

National Planning Association, Renegotiation of Defense Contracts, A Statement of the Business Committee on National Policy, Special Report No. 28 (Washington: National Planning Association, 1950).

1. Some representatives of industry state that existing procurement techniques, if adequately utilized, are sufficient to prevent excessive profits. The Department of Defense has such a multitude of contract types available, particularly price redeterminable types, that the proper use of these will insure close contractor pricing and will prevent a contractor from realizing excessive profits.

The authority on this subject is the Department of Defense itself.

Defense spokesmen have stated and testified repeatedly that the Department does not possess contracting techniques that can cope with all situations, particularly in the aircraft, space, and missile fields. In these fields technological advancements are so rapid that a contract usually has to be amended several times before it is completed. There is no way of accurately forecasting costs at the commencement of a contract, or even when it has been partially completed. One contractor may benefit substantially by use of innovations devised by another contractor in the same field. The Department feels that such windfall benefits should not accrue to the contractor because the savings realized in the performance of the contract are not due to the efficiency of the contractor.

Price redetermination usually deals with contracts on an individual basis. So, if costs have been established for one contract and the contractor then assumes another contract, the fixed costs must then be allocated to each of the two products to establish the price of each. This price redetermination on a separate contract basis would involve disagreement as to the proper allocation to each product. Renegotiation of the contractor's over-all business is not concerned with the allocation of costs to particular product lines, but with the total costs incurred in renegotiable business.

Another reason why the Defense procurement officer is at a disadvantage in determining costs is that contractors can hire experts in their

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rields and supply them with internal cost and operating data that are not evailable to military procurement officers who must rely on the contractor to a great extent for cost information. The military procurement officers cannot attain the expertise of professionals because they are concerned with the procurement of various types of items and because they, in accordance with military career development planning, may hold a procurement billet for only a relatively short time.

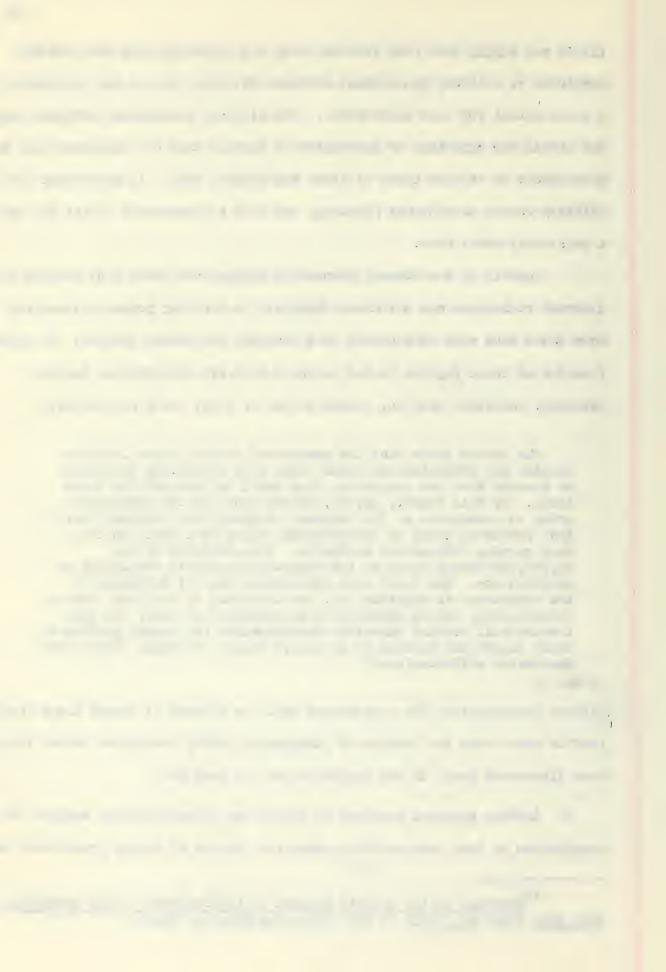
Reports by the General Accounting Office have shown that present procurement techniques are not always adequate in assuring proper pricing and have shown that some contractors have realized emorbitant profits. An excerpt from one of these reports on the Lockheed Aircraft Corporation, Georgia Division, Marietta, Georgia, issued in May of 1959, reads as follows:

The report shows that the negotiated target prices included amounts for subcontracted items which were \$4,100,600 in excess of amounts that the contractor knew would be incurred for these items. Of this amount, \$2,644,000 was known to the contractor prior to submission of its proposal, although the proposal stated that estimated costs of subcontracted items were based on the most current information svailable. The remainder of the \$1,266,600 became known to the contractor prior to completion of negotiations. The lower cost information was not furnished by the contractor in negotiations, nor disclosed by Air Force review. Consequently, unless appropriate adjustments are made, the contractor will receive incentive participation and target profits of about \$1,250,000 because of excessive target estimates rather than contractor efficiencies.17

Without renegotiation the contractors would be allowed to retain these large profits which were the results of inadequate pricing techniques unless they were discovered prior to the completion of the contract.

2. Another argument proposed by industrial representatives against remegotiation is that renegotiation makes for the use of sloppy procurement and

¹⁷ Hearings on the General Subject of an Extension of the Renegotiation Act, 1959, op. cit., p. 42. Other examples pp. 41-46.

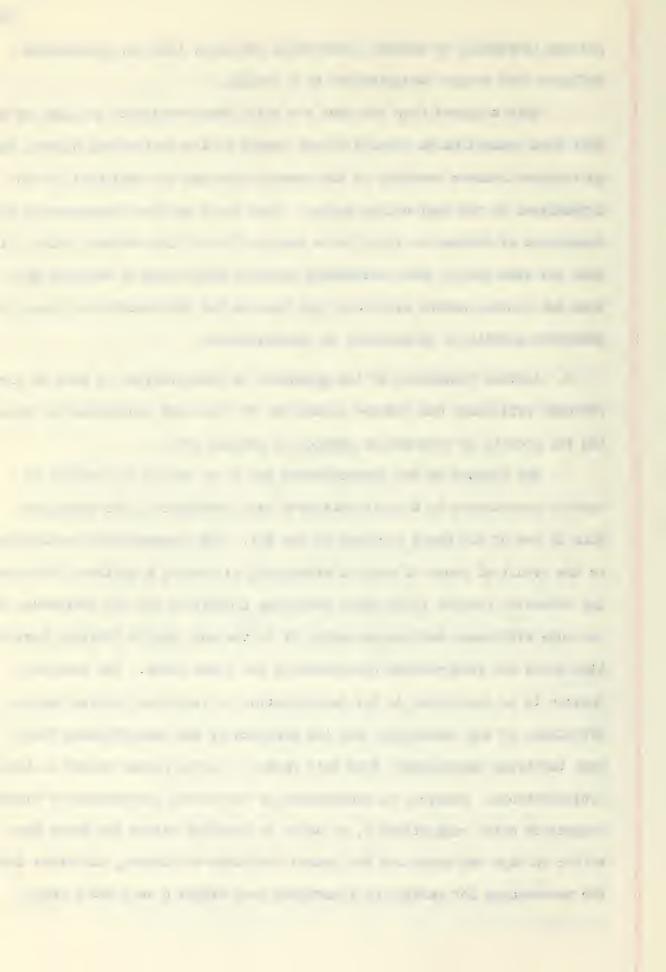


pricing techniques by defense procurement officers, that is, procurement officers tend to use renegotiation as a crutch.

This argument does not seem too valid when considered in light of the fact that renegotiation refunds do not revert to the contracting agency, but go to miscellaneous receipts in the Treasury and are not available for reexpenditure by the contracting agency. When every service department in the Department of Defense is vying for a larger slice of the defense dollar, it does not seem likely that contracting officers will spend or obligate more than the minimum amount necessary just because the Government will recoup the excessive profits of contractors by renegotiation.

3. Another contention of the opponents of renegotiation is that it discourages efficiency and reduces incentives for low-cost production by reducing the profits of contractors engaged in defense work.

The purpose of the Renegotiation Act is to reduce the profits of defense contractors by amounts that have been determined to be excessive. This is one of the basic purposes of the Act. The renegotiation legislation is the result of years of work at attempting to develop a system of eliminating excessive profits while still providing incentives for the contractor to increase efficiency and reduce costs; it is the only profit limiting legislation which has incorporated consideration for these items. The statutory factors to be considered in the determination of excessive profits include the efficiency of the contractor, and the Chairmen of the Renegotiation Board have testified consistently that this factor is given proper weight in their determinations. However, an examination of the profit percentages of various industries after renegotiation, as shown in hearings before the House Committee on Ways and Means and the Senate Committee on Finance, indicates that the percentages for particular industries vary within a very small range

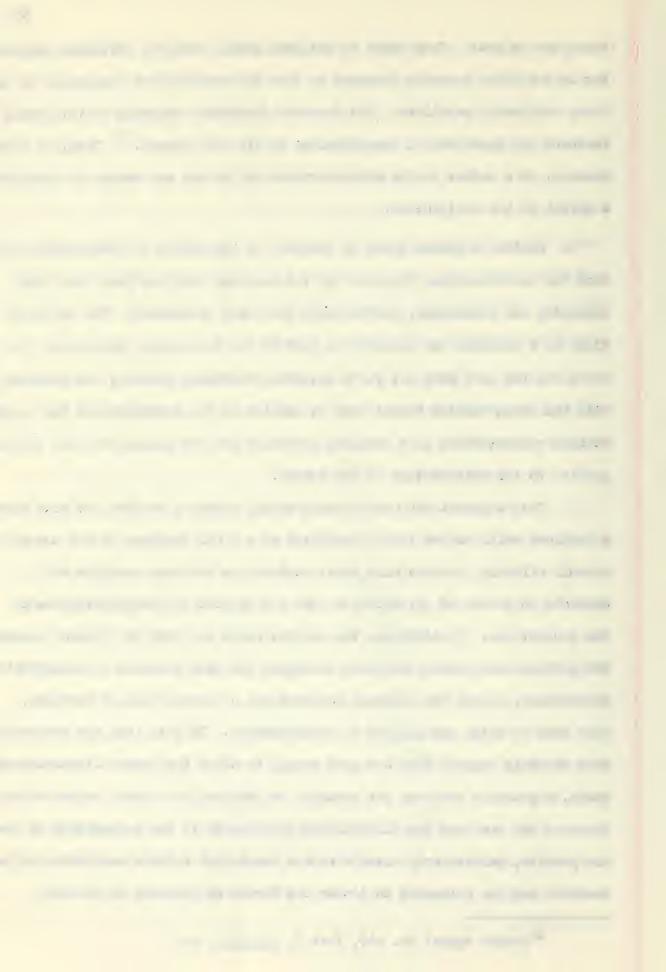


from year to year. This seems to indicate either that the efficient contractor is not tor is not being properly rewarded or that the monefficient contractor is not being adequately penalized. The Brewster Consulttee commented on this small variance for World War II renegotiation in its 1945 report. 18 This, if true, however, is a defect in the administration of the Act and cannot be considered a defect in the legislation.

4. Another argument given by industry in opposition to renegotiation is that the record-keeping required and the dealings with the Board are time-consuming and burdensome, particularly for small businesses. The tax functions in a business can normally be left to the accounting departments, because the tax laws have set forth specific standards; however, the dealings with the Renegotiation Boards must be handled by top executives of the company, because renegotiation is a judgment procedure and the executives must justify profits to the satisfaction of the Boards.

This argument has considerable merit; however, it does not seem that a business which can be truly classified as a small business is not too adversely affected, because only those contractors who have receipts and accruals in excess of \$1,000,000 a year are subject to renegotiation under the present law. In addition, the records which are kept for Federal incometax purposes are usually adequate to supply the data required in renegotiation proceedings, unless the business manufactures a diverse line of products, only some of which are subject to renegotiation. In this case the contractor must maintain records that are good enough to allow the proper allocation of costs, a practice that may not normally be followed in a small organization. Congress has realized the difficulties encountered in the segregation of costs and profits, particularly where standard connercial article manufacturing is involved and has attempted to lessen the burden on business by various

¹⁸ Senate Report No. 440, Part 2, op. cit., p. 7.



amendments to the standard commercial article and standard commercial service exemptions.

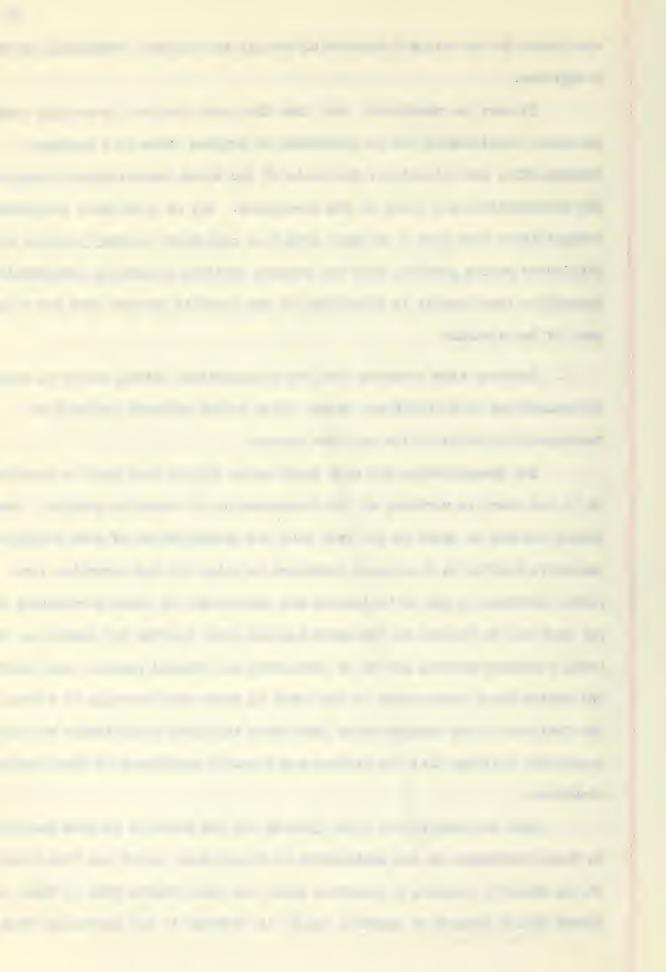
It must be remembered, too, that the costs incurred in meeting renegotiation requirements can be considered as expense items by a business.

Consequently, and ultimately, the costs of the extra record-keeping required for renegotiation are borne by the Government. If, as experience indicates, renegotiation does have a salutary effect on contractor pricing policies and eliminates excess profits, then the expense involved in meeting renegotiation accounting requirements is outweighed by the benefits derived from the existence of the statute.

5. Industry also contends that the Renegotiation Boards arrive at their determinations in an arbitrary manner which defies rational analysis or retrospective review by the appelate courts.

The Renegotiation Act sets forth seven factors that must be considered by the Board in arriving at its determination of excessive profits. The entire statute is based on the fact that the determination of what constitutes excessive profits is a judgment procedure in which all the variables that affect different types of businesses are considered—no fixed percentages of any sort are to be used as standards against which profits are measured. The seven statutory factors are to be considered and weighed against each individual contractor's performance by the Board in their consideration of a case. The Chairmen of the Renegotiation Board have testified consistently at congressional hearings that the factors are properly considered in their determinations.

What the contractors would like is for the Board to be more specific in their statements to the contractors as to how much weight has been attached to the specific factors, a procedure which the Board states that it feels it cannot follow because no specific weight is attached to any particular factor.



Renegotiation is an over-all retrospective review of a contractor's performance, and the amount of profits determined by the Board to be excessive is stated in a total dollar amount and not as a percentage of sales or net worth.

The primary benefit derived from the renegotiation procedure as contrasted to other profit limitation systems is that a determination of what constitutes excessive profits does depend on judgment and a consideration of all factors that are involved in the performance of contracts, and is not an inflexible procedure that will work hardships on a business under certain circumstances and permit excessive profits under other circumstances.

6. Another argument proposed by industry representatives is that the cost of renegotiation to the Government and to the economy is excessive.

As of June 30, 1959, the Renegotiation Board had made refund determinations of excessive profits amounting to \$783,812,931 under the provisions of the 1951 Act. 19 In addition, voluntary refunds and price reductions—these voluntary refunds and price reductions are not connected with price reductions made under price redeterminable contracts—by contractors amounted to \$1,033,862,401. The total of these two items is \$1,817,675,332. After allowance for tax credit in the amount of \$1,136,800,000 and expenses incurred in the administration of renegotiation of \$2,656,548, total net recoveries of the Board cumulative to June 30, 1959 amounted to \$678,218,734. Additional refund determinations of \$45,633,402 as of June 30, 1959, had not yet been made final. While the net refund figure cannot be taken as an absolute criterion for determining whether the cost of renegotiation is excessive because so data are available on the contractors' costs in complying with renegotiation requirements, it does show that excessive profits do exist in defense contracts.

¹⁹U. S., Renegotiation Board, Fourth Annual Report (Washington: U. S. Government Printing Office, 1959). All refund data in this discussion obtained from pp. 5-13 of the report.

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repeatedly that renegotiation has a salutary effect on pricing; what the pricing of defense procurement would be without renegotiation is conjecture, but in view of past experience with renegotiation it seems logical to opine that it does hold down the prices of defense materials. When defense contract profits are considered in view of the earlier mentioned General Accounting Office reports, it seems quite evident that renegotiation does have a fertile field in which to make its effects felt and it seems only logical that one of the effects of renegotiation is more reasonable pricing by the contractor.

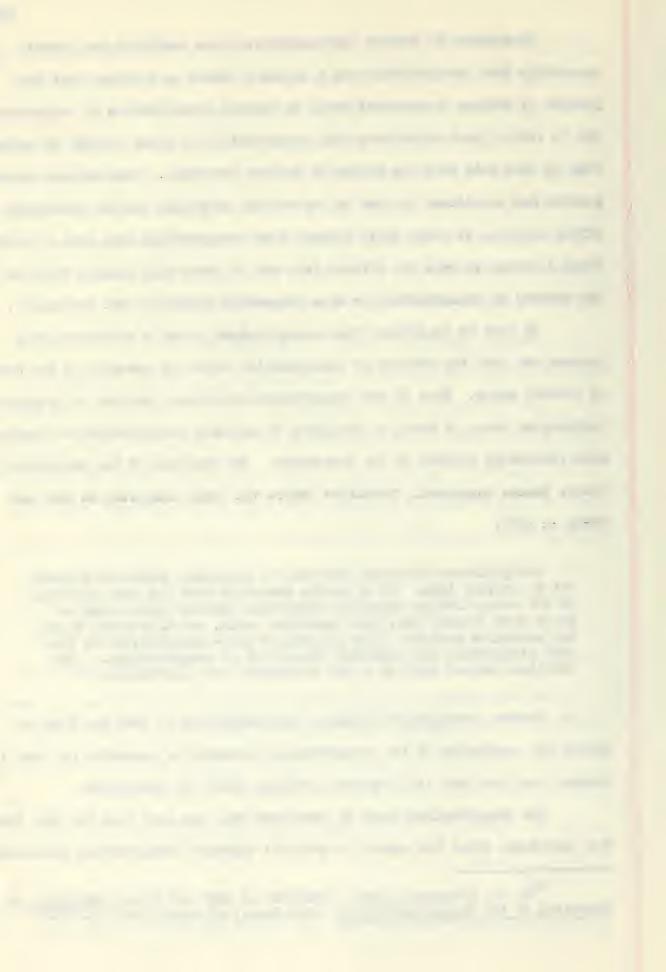
It must be remembered that renegotiation is not a revenue raising process and that the effects of renegotiation cannot be measured by the amount of refunds alone. Even if the renegotiation procedure resulted in an apparent bookkeeping loss, it would be desirable to maintain renegotiation to insure more reasonable pricing by the contractor. The Chairman of the Renegotiation Board, Thomas Coggeshall, testified before the House Committee on Ways and Means in 1958:

Renegotiation functions not only to recepture excessive profits, but to prevent them. It is common knowledge that the mere existence of the renegotiation authority frequently induces contractors to price more closely than they otherwise would, and thus avoid accruing excessive profits. This process of self-renegotiation is the most significant and important by-product of renegotiation. The resultant dollar savings to the Government are incalculable.

7. Another complaint of industry representatives is that the time required for completion of the renegotiation procedure is excessive and that a company does not know its financial standing until its completion.

The Renegotiation Board is permitted only one year from the date that the contractor files his report in which to commence renegotiation proceedings

^{20.} S., Congress, House, Committee on Ways and Means, Hearings, On Extension of the Renegotiation Act, 35th Cong., 2d Sess., 1958, p. 23.

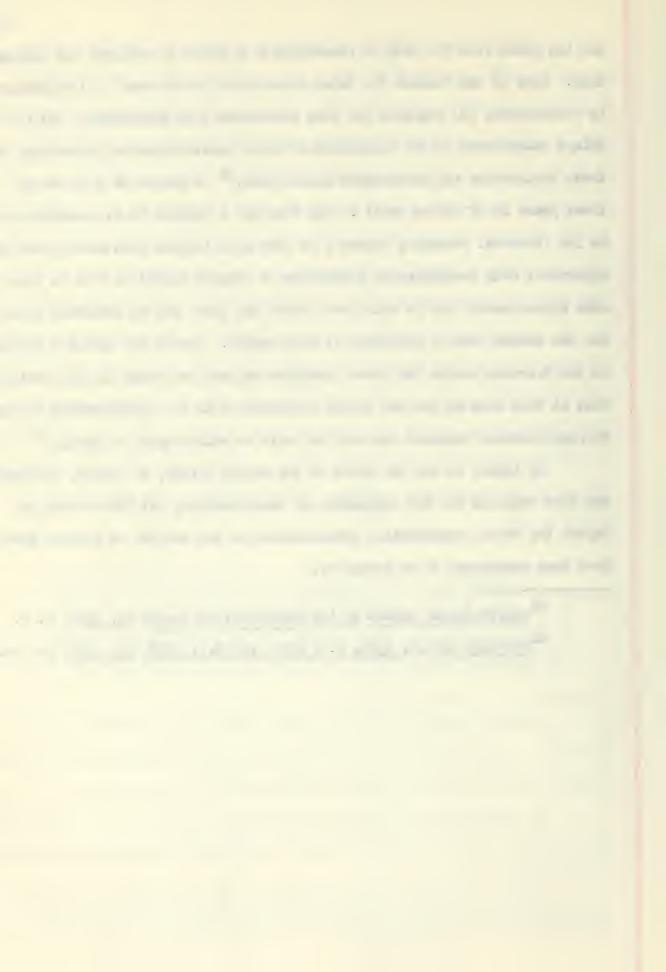


and two years from the date of commencement in which to complete the proceedings. Some of the reasons for delay beyond this period are: (1) delinquencies by contractors, (2) requests for time extensions from contractors, and (3) delays encountered in the conclusion of price redetermination proceedings between contractors and procurement authorities. 21 A period of from one to three years is of course still a long time for a company to be uncertain as to its financial position; however, it does seem logical that after years of experience with renegotiation proceedings a company should be able to estimate approximately how it will fare before the Board and to establish reserves for the amount that it estimates it must refund. One of the industry witnesses in the Hearings before the House Committee on Ways and Means in 1943 stated that at that time he had had enough experience with the renegotiation process to approximately forecast how much he would be called upon to refund. 22

An Appeal to the Tax Court of the United States, of course, increases the time required for the completion of renegotiation, but this action is beyond the basic renegotiation determination of the amounts of profits that have been determined to be excessive.

Fourth Annual Report of the Renegotiation Board, op. cit., p. 7.

²² Hearings on H.R. 2324, H.R. 2698, and H.R. 3015, op. cit., p. 582.



CHAPTER IV

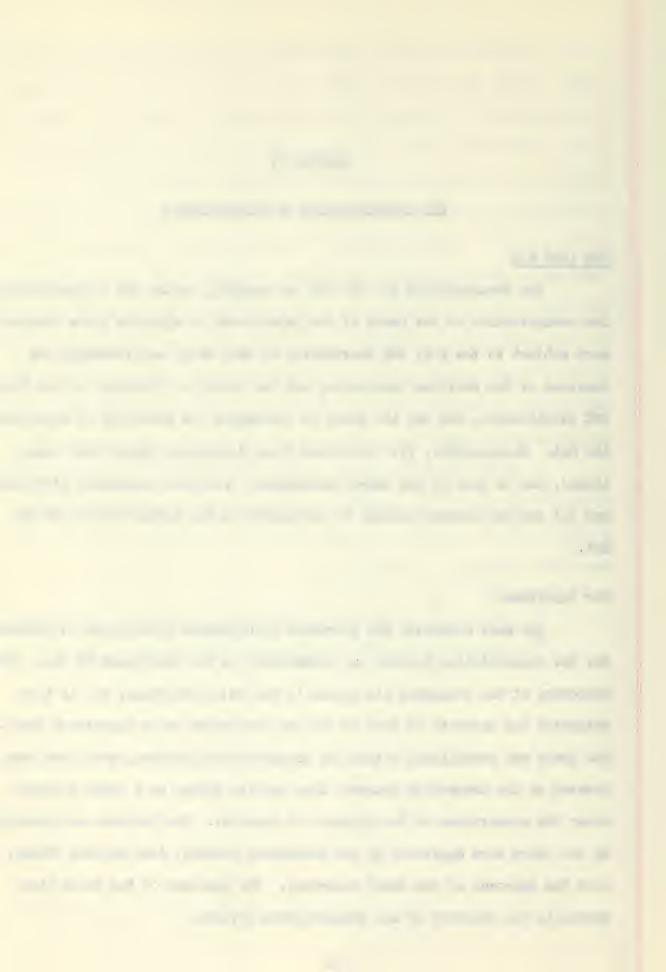
THE ADMINISTRATION OF RENEGOTIATION

The 1942 Act

The Renegotiation Act of 1942, as amended, vested the responsibility for renegotiation in the heads of the departments or agencies whose contracts were subject to the Act, the Secretaries of War, Navy, and Treasury; the Chairman of the Maritime Commission; and the Boards of Directors of the four RFC subsidiaries, who had the power to redelegate the authority to administer the Act. Consequently, five different Price Adjustment Boards were established, one in each of the named departments, which were organized differently and did not use uniform methods or procedures in the administration of the Act.

War Department

The most extensive and intricate organization established to administer the renegotiation process was established in the Department of War. The Secretary of War delegated his powers to the Under Secretary, who in turn delegated the majority of them to the War Department Price Adjustment Board. The Board was established within the Renegotiation Division, which had been created by the Commanding General, Army Service Forces as a staff division under the supervision of the Director of Material. The Chairmen and members of the Board were appointed by the Commanding General, Army Service Forces, with the approval of the Under Secretary. The Chairman of the Board also served as the Director of the Renegotiation Division.



A Price Adjustment Section was established in each of the Technical Services of the Army and in the Army Air Forces. These Services established subordinate District Price Adjustment Sections at the various procurement centers. The number of Price Adjustment Sections in operation at one time varied, but generally was around forty-five.

The War Department Price Adjustment Board functioned primarily as a policy-making and reviewing agency, although it did handle difficult or complicated cases. The Board approved all recommendations and settlements proposed by the Technical Services. The Assignments Section of the Renegotiation Division was responsible for determining which companies were renegotiable. Contractors were not required to file with the Board; the information was obtained by checking income-tax returns, company annual reports, from the Securities and Exchange Commission, procurement officers, and other sources of business data. After the Section had determined that a particular contractor was subject to the Act he was assigned to the Service which had the preponderant interest in the production of the contractor involved. The Service further assigned his case to the District Frice Adjustment Section located nearest the contractor.

A Cost-Analysis Section attached to the District Price Adjustment Section obtained financial and production data from the contractor and made an analysis for the renegotiator assigned to the case. The information was normally obtained by correspondence. Sometimes visits were made to the contractor's plant, but audits were not normally conducted. After the renegotiator had familiarized himself with the analysis and reached some preliminary conclusions, he met with the company officials for a discussion of their case. Subsequent to the conference the renegotiator met with the Chief of the Section and they jointly determined the amount of excessive profits. This decision was then conveyed to the company officials. After the contractor had

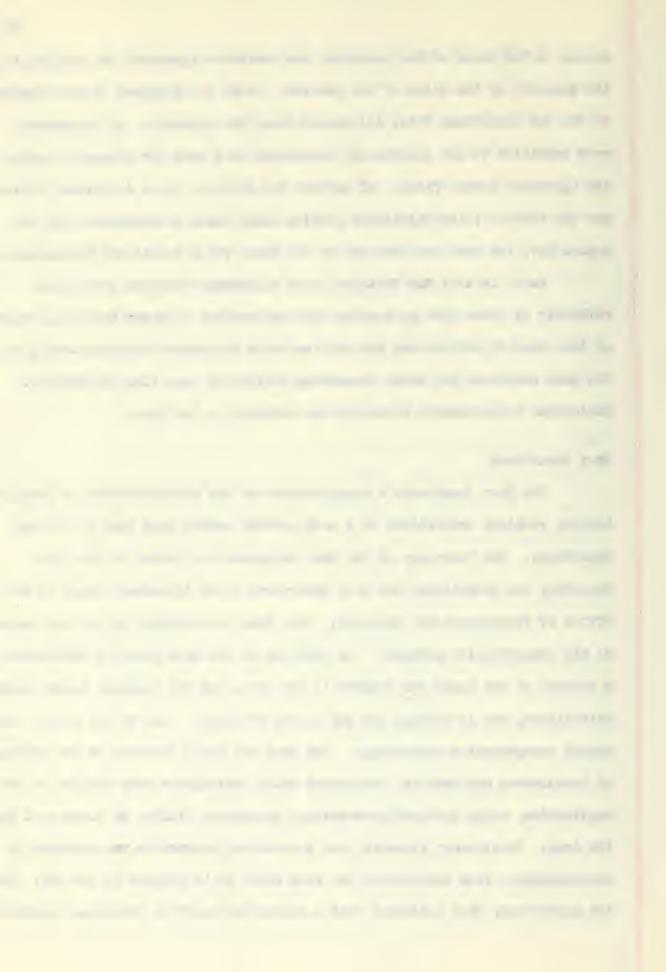


agreed to the terms of the decision, the tentative agreement was subject to the approval of the Chief of the Service. After his approval it was submitted to the War Department Price Adjustment Board for approval. All agreements were submitted to all departments interested in a case for signature before the agreement became final. If neither the District Price Adjustment Section nor the Service Price Adjustment Section could reach an agreement with the contractor, the case was referred to the Board for a unilateral determination.

Early in 1943 the District Price Adjustment Sections were given authority to enter into agreements with contractors in cases involving profits of less than \$5,000,000 and the Service Price Adjustment Sections were given the same authority for cases concerning profits of less than \$10,000,000. Unilateral determination authority was retained by the Board.

Navy Department

The Navy Department's organization for the administration of renegotiation remained centralized to a much greater extent than that of the War Department. The Secretary of the Navy delegated his powers to the Under Secretary who established the Navy Department Price Adjustment Board in the Office of Procurement and Material. This Board established policy and reviewed all renegotiation actions. In addition to the main Board in Washington, a section of the Board was located in New York, and two regional boards were established, one in Chicago and one in San Francisco. All of the Boards conducted renegotiation proceedings. The Cost and Audit Division of the Office of Procurement and Material determined which contractors were subject to renegotiation, using information-obtaining procedures similar to those used by the Army. Preliminary financial and production information was obtained by correspondence from contractors who were found to be subject to the Act. If the preliminary data indicated that a contractor might be realizing excessive



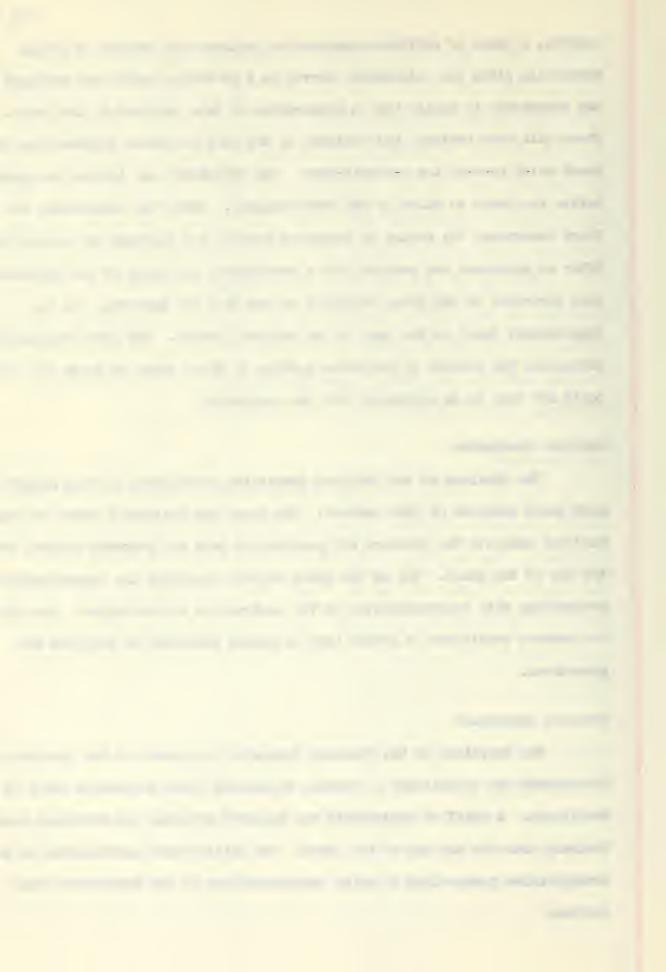
profits, a panel of auditors—composed of partners and members of public accounting firms who voluntarily served on a part-time basis—was assigned to the contractor to assist him in preparation of data required by the Board. These data were reviewed and analyzed by the Cost and Audit Division for the Board which handled the renegotiation. The contractor was invited to appear before the Board to which he had been assigned. After the conference, the Board determined the amount of excessive profits and informed the contractor. After an agreement was reached with a contractor, the terms of the agreement were forwarded to the Under Secretary of the Navy for approval, via the Departmental Board in the case of the regional boards. The Under Secretary determined the amounts of excessive profits in those cases in which the boards could not come to an agreement with the contractor.

Maritime Commission

The Chairman of the Maritime Commission established a Price Adjustment Board composed of four members. The Board was assigned a staff of accountants and analysts who obtained all preliminary data and prepared reports for the use of the Board. Two of the Board members conducted the renegotiation proceedings with representatives of the contractors in Washington. The other two members constituted a review body to assure adherence to policies and procedures.

Treasury Department

The Secretary of the Treasury delegated his powers to the Director of Procurement who established a Treasury Department Price Adjustment Board in Washington. A staff of accountants and analysts obtained and developed preliminary data for the use of the Board. The entire Board participated in the renegotiation proceedings to which representatives of the contractors were invited.



Reconstruction Finance Corporation

The Boards of Directors of the Defense Plant Corporation, the Metals
Reserve Company, the Defense Supplies Corporation, and the Rubber Reserve
Company delegated all of the authority conferred on them to a joint board
known as the Reconstruction Finance Corporation Price Adjustment Board. The
RFC Board was located in Washington and functioned in a manner similar to that
of the Maritime Commission Board.

Coordination of Administration

In January 1943 the Secretaries of the Departments cross-delegated suthority so that the department conducting renegotiation with a contractor who did business with several departments could sign an agreement that was binding on all departments, thus eliminating a period of delay in the completion of the proceedings.

In order to bring about a greater degree of uniformity and coordination in the procedures and policies of the various departments, the Joint Price Adjustment Board was established late in 1943 by mutual agreement among the Secretaries. The Board was composed of one representative from each agency and one from the War Production Board. It was delegated the authority to establish rules for all departments, to assign contractors for renegotiation, and to interpret and apply regulations. The Assignments and Statistics Branch of the Army Renegotiation Division was authorized to act for the Board in the assignment of contractors to appropriate Departments.

The 1943 Act

The Renegotiation Act of 1943 made the contracts of War Shipping Administration subject to the Act, created the War Contracts Price Adjustment Board, and required defense contractors to file an annual statement with the Board.



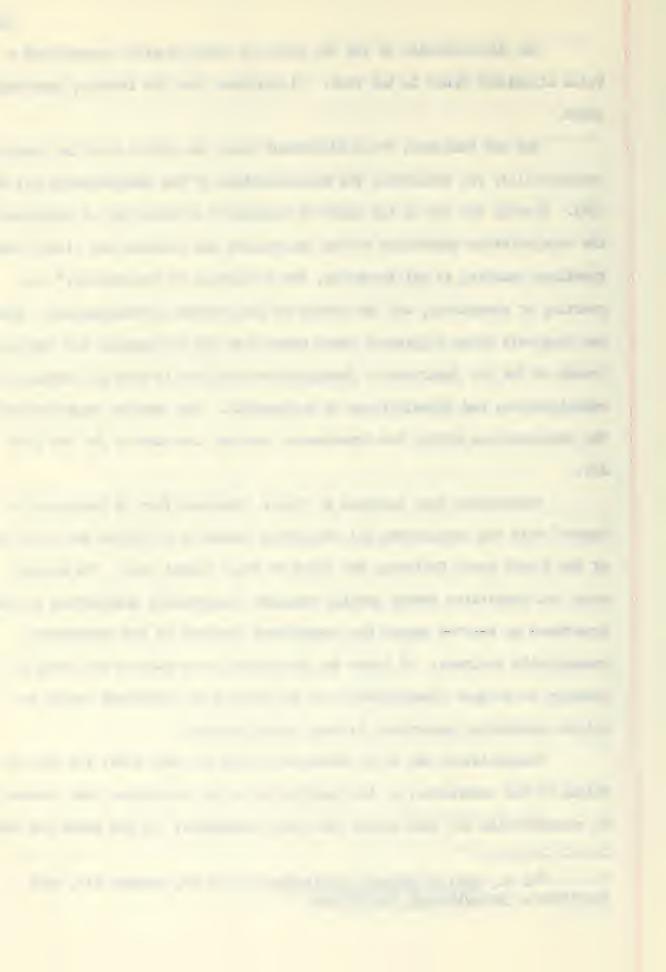
The Administrator of the War Shipping Administration established a Price Adjustment Board in New York. It operated like the Treasury Department Board.

The War Contracts Price Adjustment Board was vested with the statutory responsibility for conducting the administration of the Renegotiation Act of 1943. Through the use of its power of delegation of authority it delegated the renegotiation operations to the Departments and retained for itself the functions relating to policy-making, the publishing of regulations, the granting of exemptions, and the review of Departmental determinations. The War Contracts Price Adjustment Board authorized the Assignments and Statistics Branch of the War Department's Renegotiation Division to make all assignments, reassignments, and cancellations of assignments. The internal organization for renegotiation within the Departments remained the same as for the 1942 Act.

Contractors were required to file a "Standard Form of Contractor's Report" with the Assignments and Statistics Branch on or before the first day of the fourth month following the close of their fiscal year. The Assignments and Statistics Branch usually assigned renegotiable contractors to the Department or Service having the predominant interest in the contractors' renegotiable business. At times the assignments were made on the basis of industry or product classification to the Service or Department having acquired specialized experience in such classification.

Renegotiation had to be commenced within one year after the date of filing by the contractor, or the liabilities of the contractor with respect to renegotiation for that fiscal year were discharged. If the Board did not

U. S., Code of Federal Regulations, Title 32, Chapter XIV, 1944
Supplement, Renegotiation Regulations.

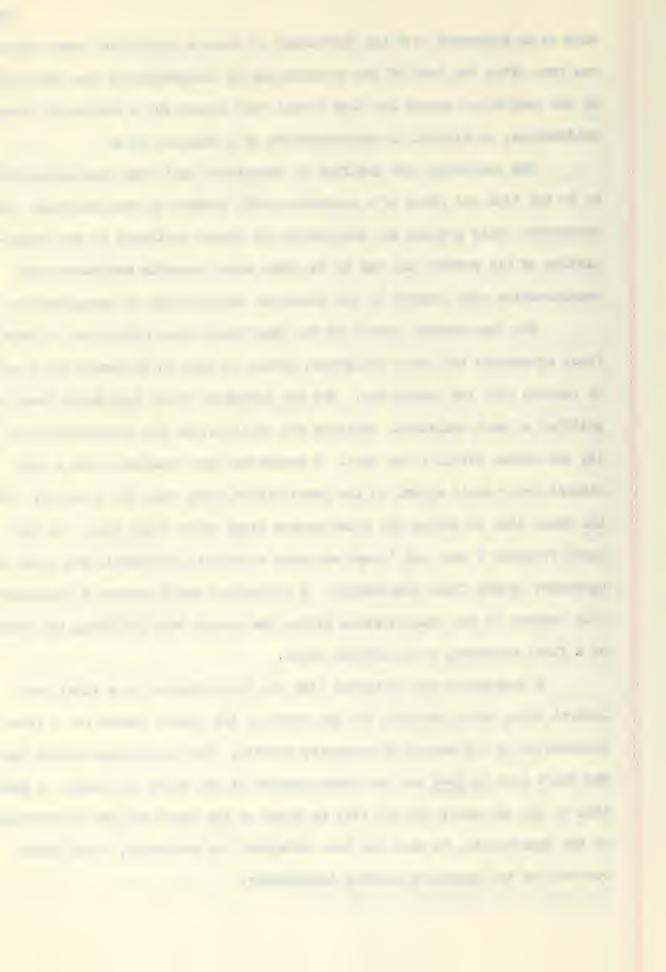


come to an agreement with the contractor or issue a unilateral order within one year after the date of the commencement of renegotiation, the liabilities of the contractor ceased for that fiscal year except for a showing of fraud, malfeasance, or willful misrepresentation of a material fact.

The contractor was notified by registered mail with reasonable notice as to the time and place of a conference with respect to renegotiation. The contractor could present any information he deemed pertinent to the renegotiation of his profits and was to be given every possible assistance and consideration with respect to the technical requirements of renegotiation.

The Departmental Boards of the Departments were authorized to make final agreements and issue unilateral orders in case an agreement could not be reached with the contractor. The War Contracts Price Adjustment Board was notified of each unilateral decision and could review the determination on its own motion within sixty days. A contractor who disagreed with a unilateral order could appeal to the Board within sixty days for a review. If the Board took no action the order became final after sixty days. If the Board reviewed a case and issued an order or made an agreement, the order or agreement became final immediately. A contractor could request a statement with respect to his renegotiation within the thirty days following the receipt of a final agreement or unilateral order.

A contractor who disagreed with the determination in a final unilateral order could petition the Tax Court of the United States for a redetermination of the amount of excessive profits. The proceedings before the Tax Court were de novo and the determination of the Court was final. A petition to the Tax Court did not stay an order of the Board and the Secretaries of the Departments, to whom had been delegated the authority, could begin recovery of the excessive profits immediately.



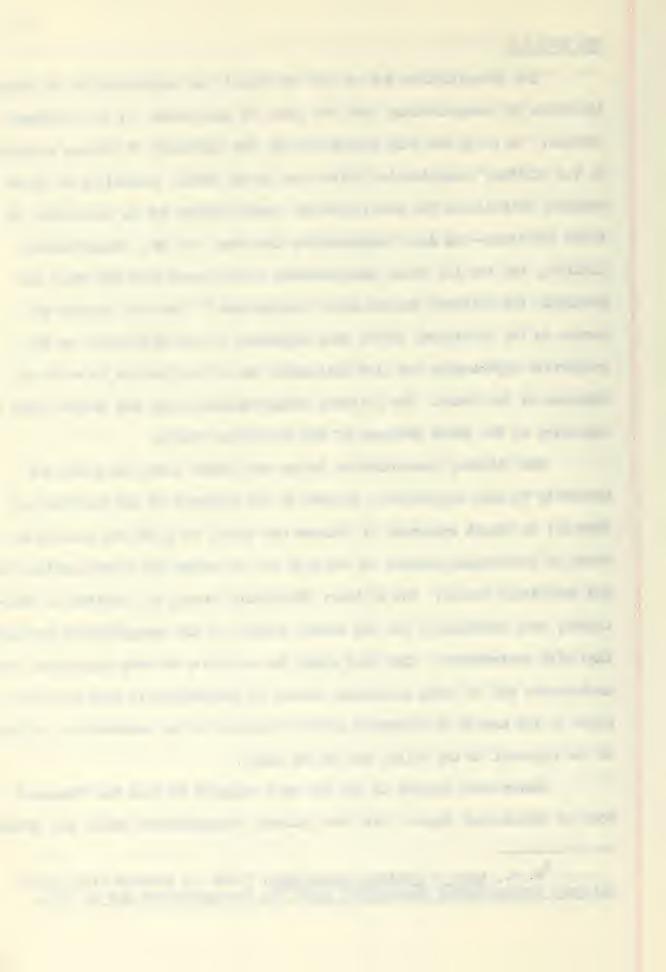
The 1948 Act

The Renegotiation Act of 1948 conferred the responsibility for administration of renegotiation, with the power of delegation, on the Secretary of Defense. To carry out this responsibility the Secretary of Defense established the Military Renegotiation Policy and Review Board, consisting of three members; established the Army Renegotiation Division, the Navy Renegotiation Division, and the Army Renegotiation Division—of five men each; and published the Military Renegotiation Regulations. The five members who served on the Divisional Boards were appointed by the Secretaries of the respective departments who also designated one of the members to serve as Chairman of the Board. The Military Renegotiation Policy and Review Board consisted of the three Chairman of the Divisional Boards.

The Military Renegotiation Policy and Review Board was given the authority to make regulations, subject to the approval of the Secretary of Defense; to exempt contracts by classes and types; to audit the records and books of contractors subject to the Act; and to review the determinations of the Divisional Boards. The Military Divisional Boards, all located in Washington, were responsible for the actual conduct of the renegotiation proceedings with contractors. They were given the authority to make agreements with contractors and to issue unilateral orders to contractors if they could not agree on the amount of excessive profits realized by the contractors, subject to the approval of the Policy and Review Board.

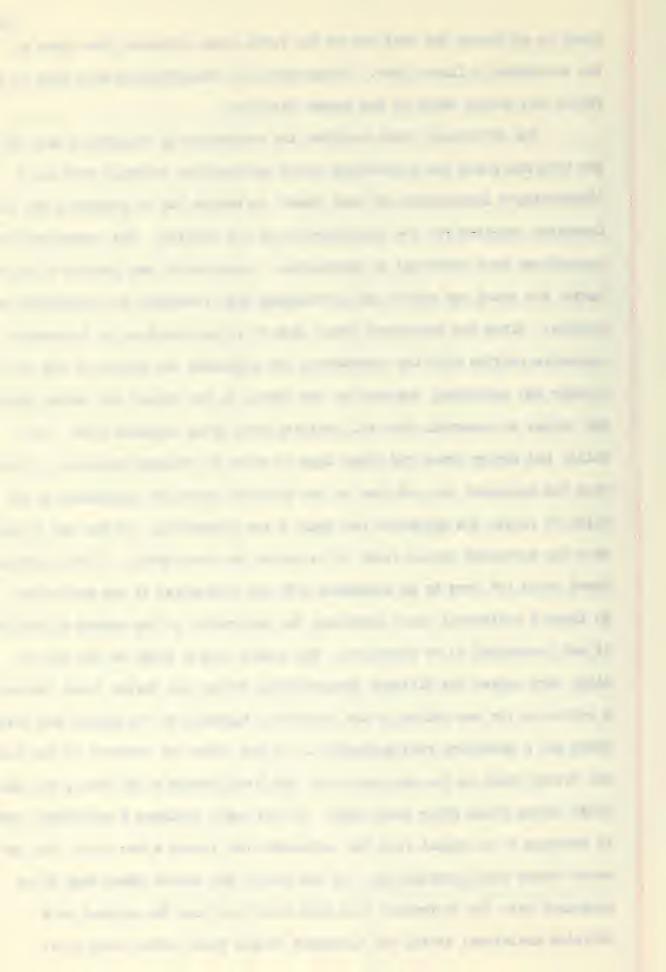
Contractors subject to the Act were required to file the "Standard Form of Contractors Report" with the Military Renegotiation Policy and Review

U. S., Code of Federal Regulations, Title 32, Chapter XIVA, 1951, Military Renegotiation Regulations under the Renegotiations Act of 1948.



Board on or before the last day of the fifth month following the close of the contractor's fiscal year. Assignments for renegotiation were made by the Policy and Review Board to the proper Division.

The Divisional Board notified the contractor by registered mail of the time and place the proceedings would commence, and normally sent him a "Contractor's Information and Work Sheet" to assist him in preparing the information required for the renegotiation of his profits. The renegotiation proceedings were conducted in Washington. A contractor was invited to appear before the Board and submit any information that concerned his production and. profits. After the Divisional Board came to an agreement as to the amount of excessive profits with the contractor, the agreement was signed by the contractor and submitted, unsigned by the Board, to the Policy and Review Board for review to ascertain that all policies were being complied with. The Policy and Review Board had sixty days in which to indicate approval, in which case the agreement was returned to the Division Board for signature, or in which to reject the agreement and begin a new proceeding. At the end of sixty days the agreement became final if no action had been taken. If the Division Board could not come to an agreement with the contractor it was authorized to issue a unilateral order informing the contractor of the amount of profits it had determined to be excessive. The orders became final at the end of sixty days unless the Military Renegotiation Policy and Review Board initiated a review on its own motion, or the contractor appealed to the Policy and Review Board for a mandatory redetermination. If the order was reviewed by the Folicy and Review Board on its own motion and the Board issued a new order, the new order became final after sixty days. If the Board reviewed a unilateral order in response to an appeal from the contractor and issued a new order, the new order became final immediately. If the Policy and Review Board came to an agreement with the contractor in a case which had been the subject of a Division unilateral order, the agreement became final after sixty days.



The Act provided no statute of limitations for either the commencement or termination of renegotiation proceedings. However, the Secretary of Defense in the Military Renegotiation Regulations stated that all proceedings should be begun and completed within fifteen months following the filing of a contractor's report.

The Secretaries of the Military Departments were delegated the authority to collect refunds of the amounts of profits which had been determined to be excessive. Refunds not made within two years after the close of the renegotiation proceedings, or the contractors renegotiated fiscal year, were subjected to an interest charge of 6 per cent per annum.

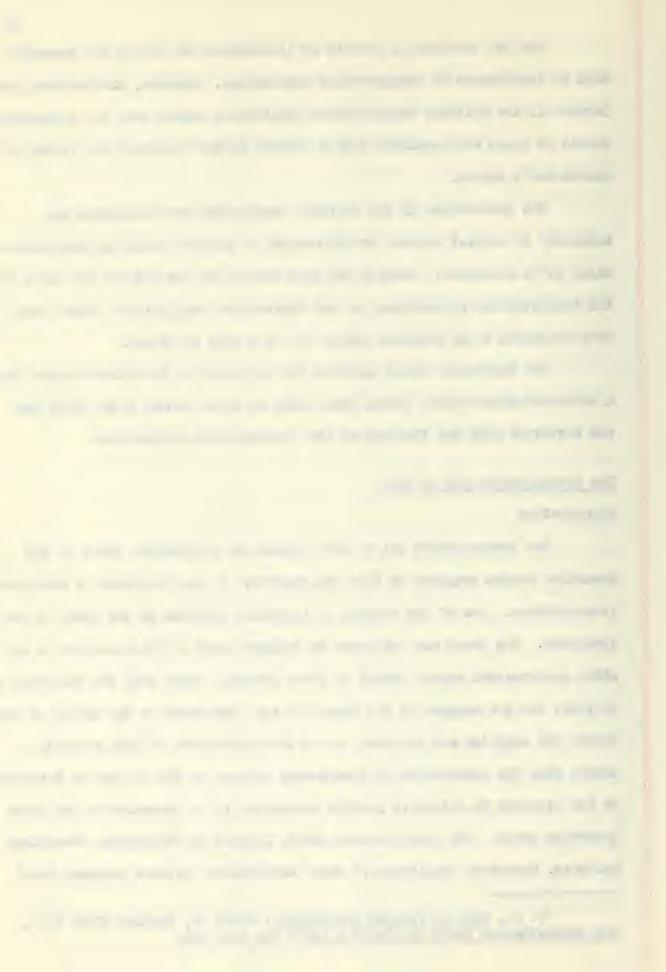
The contractor could petition the Tax Court of the United States for a redetermination within ninety days after an order became final if he was not satisfied with the findings of the renegotiation authorities.

The Renegotiation Act of 1951

Organization

The Renegotiation Act of 1951 created an independent board in the executive branch composed of five men appointed by the President to administer renegotiation. One of the members is appointed Chairman of the Board by the President. The Board has the power to delegate some of its authority to any other governmental agency except to those persons, other than the Secretary of Defense, who are engaged in the behalf of any Department in the making of contracts for supplies and services, or in the supervision of such activity, except that the Secretaries of Departments subject to the Act may be authorized and directed to eliminate profits determined to be excessive by the Ranegotiation Board. The Renegotiation Board, located in Washington, determines policies, publishes regulations, makes assignments, reviews Regional Board

³U. S., Code of Federal Regulations, Title 32, Chapter XIVB, 1954, The Renegotiation Board Regulations Under the 1951 Act.



determinations, and grants permissive exemptions. It has, at the present time, three Regional Boards which conduct actual renegotiation proceedings.

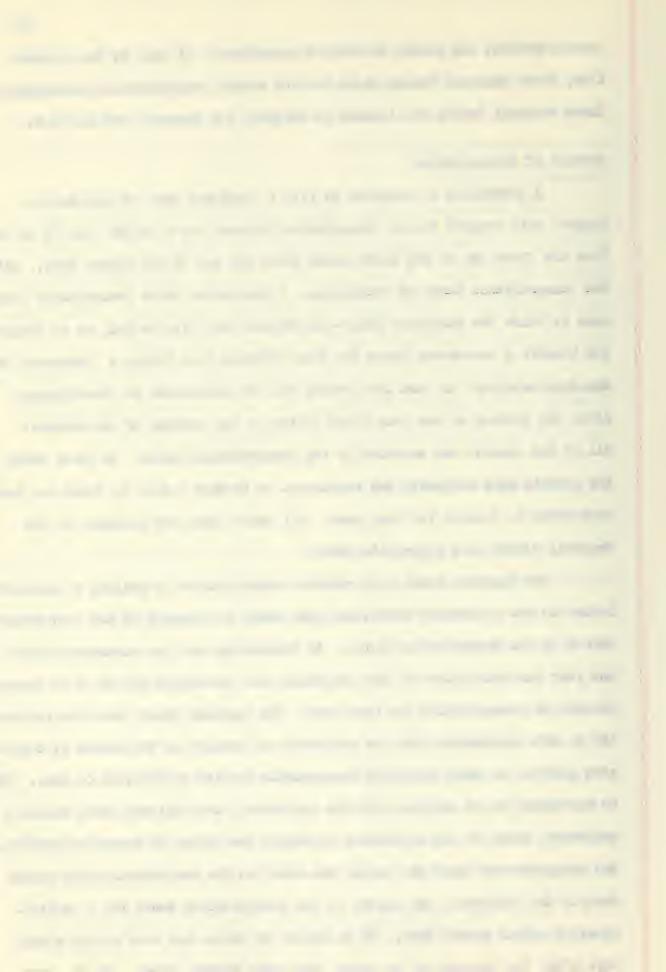
These Regional Boards are located in Detroit, Los Angeles, and New York.

Conduct of Renegotiation

A contractor is required to file a "Standard Form of Contractor's Report" with respect to his renegotiable business for a fiscal year on or before the first day of the fifth month after the end of his fiscal year, with the Renegotiation Board in Washington. A contractor whose renegotiable business is below the statutory floor—\$1,000,000—may file or not, as he chooses. The benefit a contractor below the floor obtains from filing a "Statement of Non-Applicability" is that his profits will be foreclosed to investigation after the passage of one year after filing by the statute of limitations.

All of the reports are examined by the Renegotiation Board. In cases where the profits were obviously not excessive, no further action is taken and the contractor is cleared for that year. All other cases are assigned to the Regional Boards on a geographic basis.

The Regional Board must commence renegotiation by mailing a registered letter to the contractor within one year after the receipt of the contractor's report by the Renegotiation Board. If proceedings are not commenced within one year the liabilities of the contractor are discharged and he is no longer subject to renegotiation for that year. The Regional Boards have the authority to make agreements with the contractor in respect to the amount of excessive profits in cases involving renegotiable profits of \$800,000 or less. If no agreement can be reached with the contractor, the Regional Board issues a unilateral order to the contractor directing the refund of excessive profits. The Renegotiation Board may review the order on its own motion within ninety days, or the contractor may appeal to the Renegotiation Board for a redetermination within ninety days. If no appeal or review are made within ninety days after the issuance of an order, the order becomes final. If the Board



reviews a case, or decides not to review a case, the order to the contractor becomes final as of the date of the mailing of the notice not to review or the date of the new order.

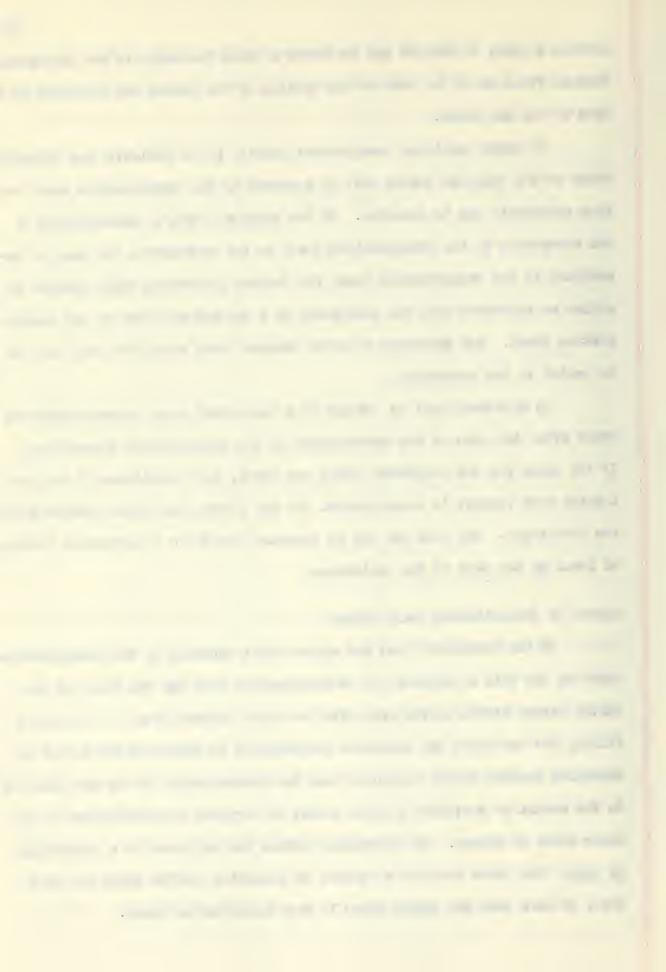
In cases involving renegotiable profits above \$300,000, the determinations of the Regional Boards must be approved by the Renegotiation Board before agreements can be executed. If the Regional Board's determination is not acceptable to the Renegotiation Board or the contractor, the case is reassigned to the Renegotiation Board for further processing which results in either an agreement with the contractor or a unilateral order by the Renegotiation Board. The agreement or order becomes final as of the date that it is mailed to the contractor.

An agreement must be reached or a unilateral order issued within two years after the date of the commencement of the renegotiation proceedings.

If the cases are not completed within two years, the liabilities of the contractor with respect to renegotiation for the fiscal year under consideration are discharged. The case may not be reopened except for a subsequent finding of fraud on the part of the contractor.

Appeal of Renegotiation Board Orders

Board he may file a petition for redetermination with the Tax Court of the United States within minety days after an order becomes final. Upon such a filing, the Tax Court has exclusive jurisdiction to determine the amount of excessive profits of the contractor and the determination of the Tax Court as to the amount of excessive profits cannot be reviewed or redetermined by any other court or agency. The proceeding before the Tax Court is a proceeding de novo. The Court can find an amount of excessive profits equal to, less than, or more than the amount found by the Renegotiation Board.



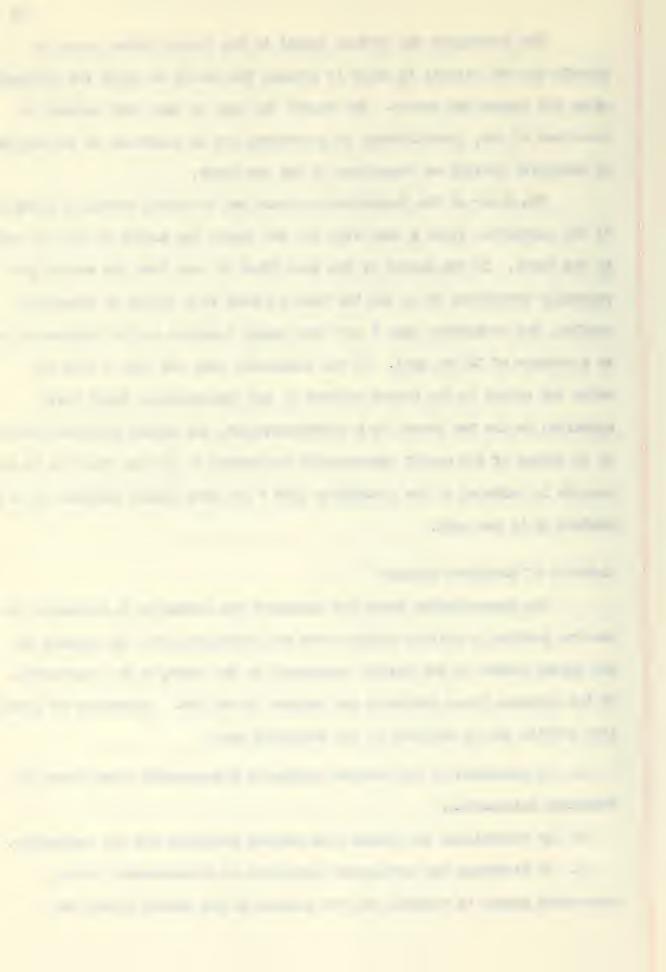
The contractor may further appeal to the United States Court of Appeals for the circuit in which is located the office to which the contractor makes his income-tax return. The appeal can only be made with respect to questions of law, jurisdiction, or procedure; not on questions of the amount of excessive profits as determined by the Tax Court.

The order of the Renegotiation Board may be stayed during an appeal, if the contractor files a bond with the Tax Court; the amount of bond is set by the Court. If the amount of the bond filed is less than the amount subsequently determined to be due the United States as a refund of excessive profits, the contractor pays 4 per cent annual interest on the difference up to a maximum of 12 per cent. If the contractor does not file a bond and makes the refund in the amount ordered by the Renegotiation Board while appealing to the Tax Court for a redetermination, the amount collected which is in excess of the amount subsequently determined by the Tax Court to be excessive is refunded to the contractor with 4 per cent annual interest up to a maximum of 12 per cent.

Recovery of Excessive Profits

The Renegotiation Board has delegated the authority to eliminate excessive profits, or collect refunds from the contractors for the account of the United States in the amounts determined by the Board, to the Secretaries of the agencies whose contracts are subject to the Act. Recoveries of excessive profits can be effected in the following ways:

- 1. By reduction in the amounts payable to a contractor under terms of contracts outstanding.
 - 2. By withholding the amount from amounts otherwise due the contractor.
- 3. By directing any government contractor or subcontractor or any government agency to withhold for the account of the United States the



amount of excessive profits from any amounts otherwise due to contractors or subcontractors having excessive profits to be eliminated and to pay these amounts to the United States.

4. By recovering from a contractor or subcontractor by repayment, eredit, or suit any amounts of excessive profits already paid the contractors.

The funds recovered go into the Treasury as miscellaneous receipts and do not revert to the agency which made the contract for reexpenditure.

CHAPTER V

CONCLUSIONS

Vinson-Tranmel Act and Merchant Marine Act

The profit limitations of the Vinson-Trammel Act and the Merchant

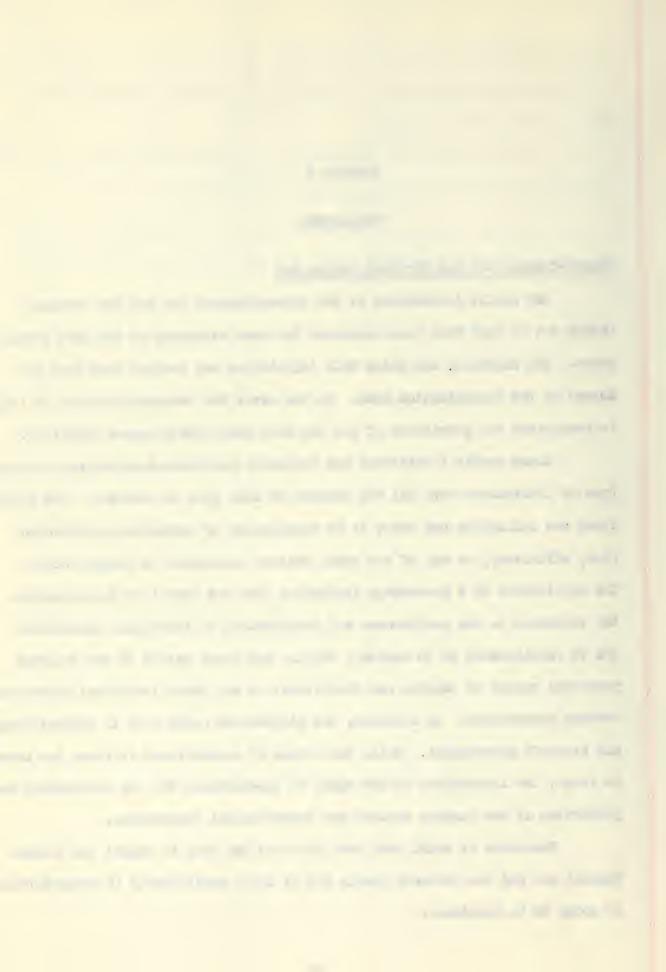
Marine Act of 1936 have been suspended for over seventeen of the last twenty

years. The functions for which this legislation was enacted have been per
formed by the Renegotiation Acts. In the event the Renegotiation Act of 1951

is terminated the provisions of the two Acts would again become effective.

These profit limitations are basically cost-plus-a-percentage-of-cost type of limitations with all the defects of this type of contract. The limitations are inflexible and there is no recognition of contractor performance, risk, efficiency, or any of the other factors considered in renegotiation. The application of a percentage limitation does not take into consideration the variation in the performance and contribution of individual contractors due to requirements as to capital, skills, and work; nature of the articles produced; source of capital and facilities; or any other individual differences between contractors. In addition, the limitations apply only to shipbuilding and aircraft procurement. While the volume of expenditures in these two areas is large, the limitations do not apply to expenditures for the development and production of new weapons systems and technological innovations.

Therefore it would seem that the time has come to repeal the Vinsonpressnel Act and the Merchant Marine Act of 1936, particularly if renegotiation is going to be continued.



Renegotiation

A study of the history of renegotiation shows that it has been effective in large degree in accomplishing the purposes for which it was enacted.

Although some areas of excessive profits during World War II have been exposed, industry on the whole has been given a "clean bill of health" as compared to the reports of profiteering during prior wars.

However, renegotiation during peacetime takes on a different aspect from wartime renegotiation. During World War II over 35 per cent of the gross national product was devoted to defense; at the present time defense expenditures for procurement account for approximately 5 per cent of the gross national product. Although expenditures for defense procurement are a relatively small portion of the gross national product, the dollar amount is greater than that expended for mobilization and defense preparedness during any previous periods of peace. Studies and investigations have shown that opportunity exists for the realization of large profits by defense contractors and subcontractors because of the difficulty of pricing new military weapons and weapons systems which are constantly undergoing change due to technological advancement and the somewhat nebulous contractual relationships between the government and subcontractors.

Opportunity for the realization of excessive profits does not reside with large contractors alone. The report on renegotiation published by the Special Senate Committee to Investigate the National Defense Program stated that 44 per cent of the companies in the \$100,000 to \$500,000 profits per year bracket made excessive profits during World War II. The reports of the Renegotiation Board established by the 1951 Act have reported a smaller percentage. The First Annual Report of the Renegotiation Board showed that

Senate Report No. 440, Part 2, op. cit., pp. 10-11.

And the same of th

cumulative to June 30, 1955, of the total amount of profits that had been determined to be excessive 15.7 per cent represented excessive profits realized by companies doing less than \$1,000,000 of business a year. The same report showed that during the fiscal year ended June 30, 1956, of the total amount of profits determined to have been excessive, this category represented only 6.2 per cent.² The report also stated:

The circumstance that the smaller cases represented larger percentages of total determinations prior to June 30, 1955, was due in large part to the fact that in the original act, the statutory floor was \$250,000 for most contractors.

The statutory floor was raised to \$500,000 for fiscal years ending after June 30, 1953 and to \$1,000,000 for fiscal years ending after June 30, 1956 to lessen the administrative burden on the Renegotiation Board and small contractors. The evidence indicates that excessive profits were and are being made by small contractors. Size alone should not be a criterion for permitting contractors to retain excessive profits.

payer are receiving full value for each dollar spent during a period of semimobilization and high defense procurement expenditures. In some procurement
areas sufficient competition among producers exists to insure the government
of fair and competitive prices. However, in other areas of defense procurement, particularly in the areas of procurement in the space, aircraft, and
missile fields little or no competition exists to assure the government of a
proper price. The lack of competition, and consequent inadequate pricing is
not restricted to these areas of procurement. A spokesman for the Department
of Defense testified in 1959 that:

²U. S., Renegotiation Board, First Annual Report (Washington: U. S. Government Printing Office, 1956), p. 6.

³ Thid.

With respect to contracts or subcontracts which have been made the subject of competitive bidding where an award has been made to a low bidder among three or more responsive competitive bidders, it is the position of the Department of Defense that such competition in the area of military items, as distinguished from commercial articles, does not guarantee against excessive profits.

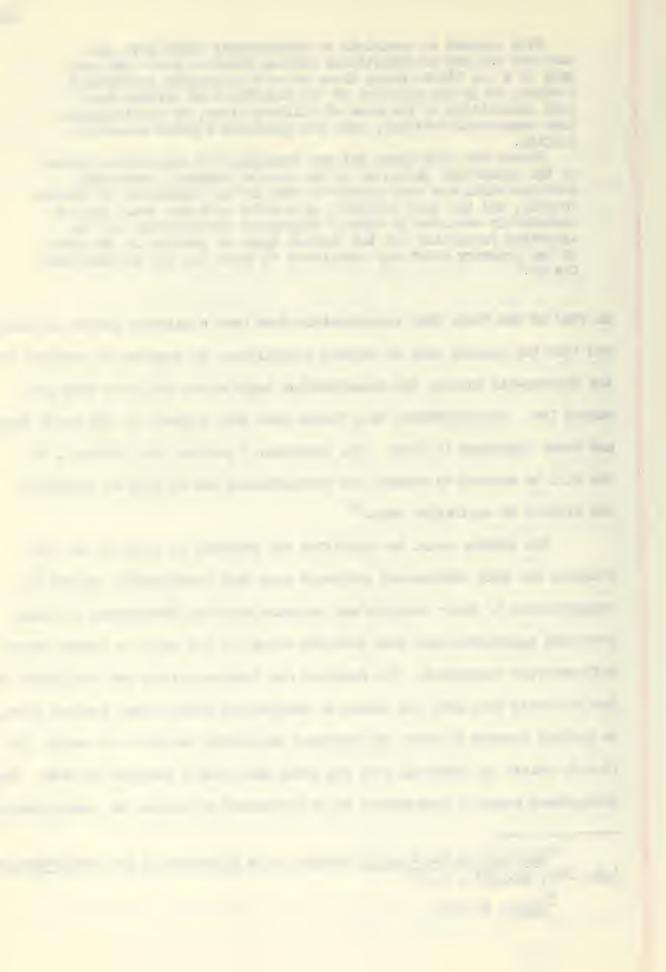
Prices for such items are not controlled by competitive forces of the commercial market as in the case of standard commercial articles which are sold elsewhere than in the Department of Defense largely, and the cost estimates upon which bids are based are not necessarily accurate in view of subsequent developments such as increased production and the various types of changes in the state of the industry which may come about in these new and extraordinary fields. 4

In view of the facts that renegotiation does have a salutary effect on pricing and that the present rate of defense expenditures is expected to continue for the foreseeable future, the renegotiation legislation should be made permanent law. Representative Carl Vinson made this proposal to the House Ways and Means Committee in 1959: "Mr. Chairman, I propose that Section 1 of the bill be amended to reenact the Renegotiation Act of 1951 as permanent law without an expiration date."

The statute could be simplified and enlarged in scope if all contractors who held defense-end contracts were made contingently subject to renegotiation if their receipts and accruals from the performance of these contracts aggregated more than \$100,000 annually, but would be exempt unless affirmatively designated. The agencies and departments who are designated in the Act would then have the burden of designating those areas, product lines, or product classes in which insufficient competition exists or in which difficulty exists in obtaining cost and price data when a contract is made. The procurement areas or contractors to be designated as subject to renegotiation,

Hearings on the General Subject of An Extension of the Renegotiation Act, 1959, op. cit., p. 14.

⁵Ibid., p. 188.



mended to the Renegotiation Board by the agencies and departments for inclusion among those to be subject to renegotiation. The Renegotiation Board should, under this plan, report to Congress annually on the status of renegotiation coverage. Congress could, of course, mandatorily exempt contracts for certain items, such as those for agricultural commodities. If it is felt that this would give an administrative agency too much authority, Congress could establish or appoint a continuing subcommittee to approve the recommendations of the departments or agencies. The product lines to be subject to renegotiation could be changed as operating and procurement experience, economic conditions, and world political conditions dictated. If competitive conditions develop in certain procurement areas, these areas could be dropped from those subject to renegotiation, or if the cold war became hot all defense contracts could immediately be made subject to renegotiation.

A revision along these lines would provide for greater flexibility and would remove the administrative burden of renegotiation from those areas where the need for it does not exist.



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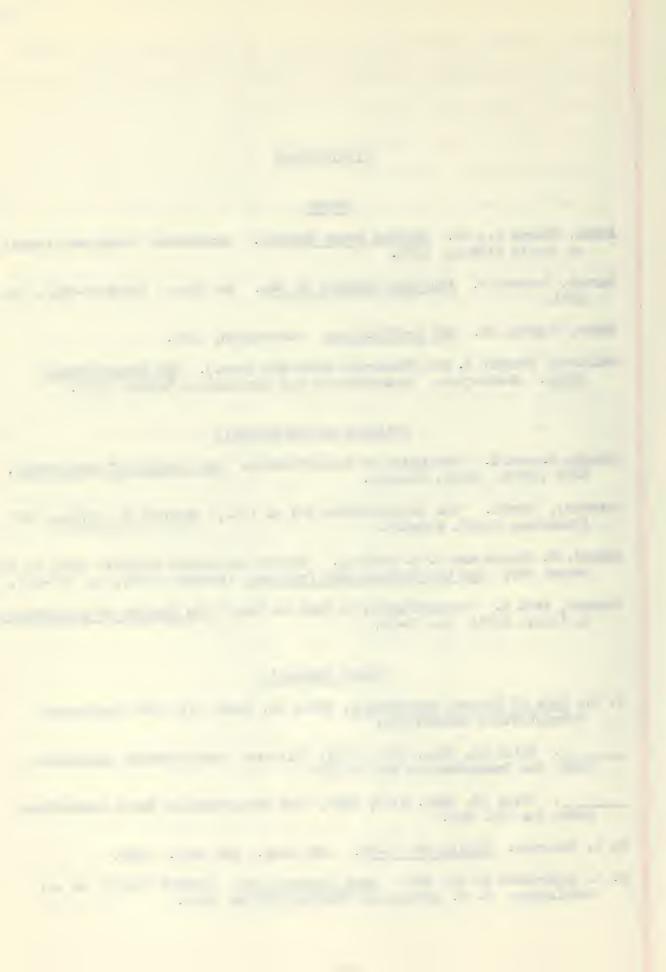
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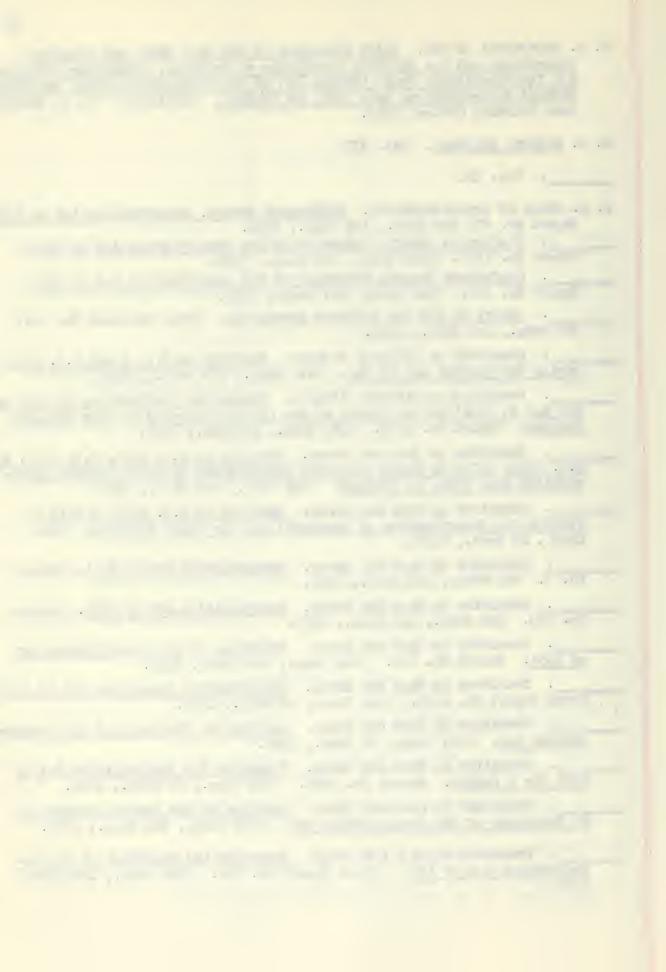
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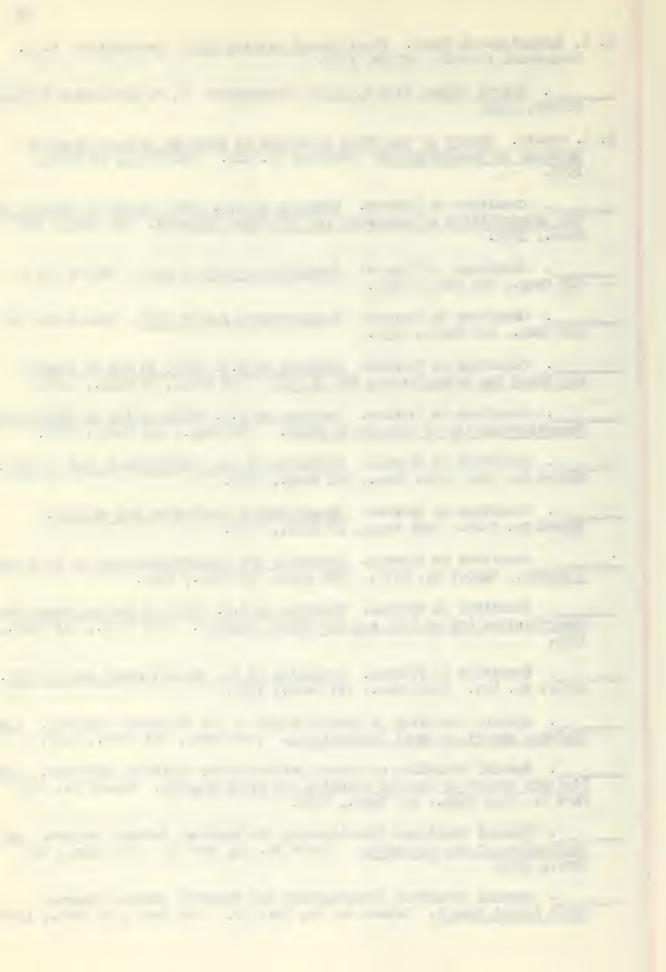


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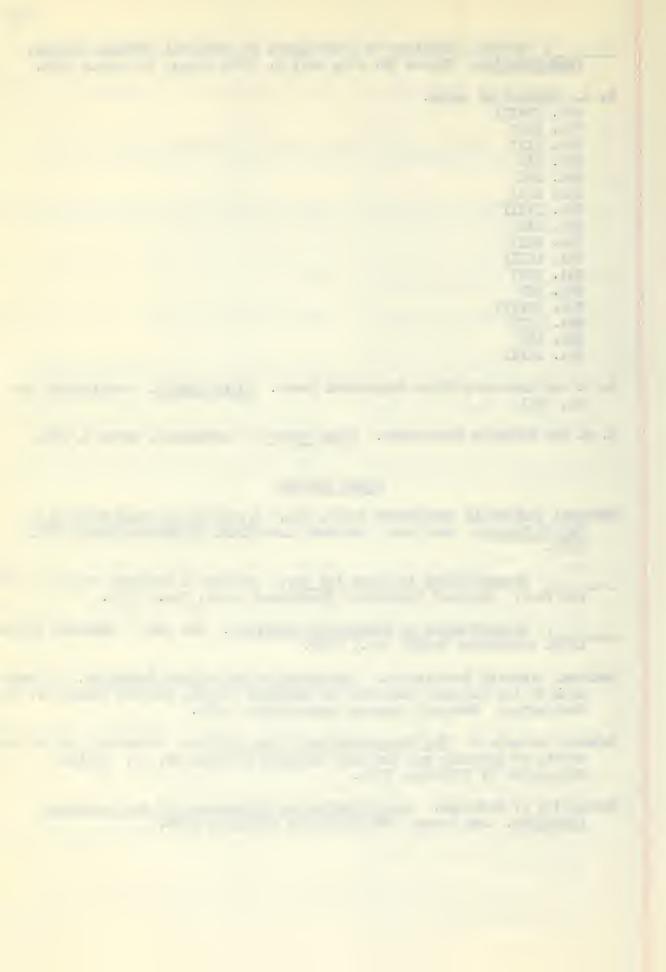
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THE UNITED STATES COAST GUARD

ACTIVITY BUDGET

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by

Graham Hall LT, USCG

